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Supreme Court of the United States

OCTOBER TERM, 1967

No. 104

**ALEXANDER TCHEREPNIN, ET AL.,
PETITIONERS,**

vs.

JOSEPH E. KNIGHT, ET AL.

**ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT**

**PETITION FOR CERTIORARI FILED APRIL 20, 1967
CERTIORARI GRANTED JUNE 5, 1967**

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[fol. A]

**IN THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT**

Nos. 15631 and 15633.

ALEXANDER TCHEREPNIN, et al., Plaintiffs-Appellees,

vs.

ROBERT FRANZ, et al., Defendants,

No. 15633

CITY SAVINGS ASSOCIATION, DENNIS KIRBY, HARRY HARTMAN
and LOUIS KWASMAN, Defendants-Appellants,

No. 15631

JOSEPH E. KNIGHT and JUSTIN HULMAN,
Defendants-Appellants.

Appeal from the United States District Court for the
Northern District of Illinois, Eastern Division.

No. 64C-1285

Honorable William J. Campbell, Chief Judge, Judge
Presiding.

Appellant's Joint Appendix—Filed July 14, 1966

[File endorsement omitted]

[fol. 3]

IN THE UNITED STATES DISTRICT COURT
FOR THE NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION
No. 64 C 1285

ALEXANDER TCHEREPNIN, et al., Plaintiffs,

vs.

ROBERT FRANZ, et al., Defendants.

COMPLAINT—Filed July 24, 1964

Plaintiffs, by their attorneys, Arnold I. Shure and Solomon Jesmer, allege as follows, except that paragraphs 16, 17, 19, 20, 21, 23, and 24 are alleged on information and belief:

[fol. 4] 1. Jurisdiction of this Court is based upon Section 27 of the Securities Exchange Act of 1934 (15 USC §78aa).

2. Defendant City Savings Association (hereafter "City Savings") is a savings and loan association incorporated and doing business under the laws of the State of Illinois. Its principal place of business is and has been at 1656 West Chicago Avenue, Chicago, Illinois, where it has done business for more than 20 years. It was the issuer and seller of the securities sold to plaintiffs, the sale and purchase of which is the subject matter of this Complaint.

3. Defendant C. Oran Mensik (hereafter "Mensik") during all times material to this cause has been, and is, a director of, president and principal executive officer of City Savings.

4. Defendant Robert M. Kramer during all times material to this cause has been, and is, a director of and a

vice-president of City Savings. He is a brother-in-law of defendant Mensik.

5. Defendant Stanley Pasko at present, and during part, and possibly all, of the times material to this cause has been, and is, a director and a vice-president of City Savings.

6. Defendant Joseph Talarico, Jr., at present and during part, and possibly all, of the times material to this cause has been, and is, a director and a vice-president of City Savings.

7. Defendant Gloria Mensik Sprincz at present and during part, and possibly all, of the times material to this cause (sic) has been, and is, a director and treasurer of City Savings. She is a daughter of Mensik.

8. Each of the defendants Robert Franz and Herbert J. Hoover, at present, and during part, and possibly all, [fol. 5] of the times material to this cause has been a director of City Savings.

9. Defendant Joseph E. Knight (hereafter "Knight") is director of the Department of Financial Institutions of the State of Illinois. Defendant Justin Hulman is supervisor of the Savings and Loan Division of said Department.

10. Defendants Louis Kwasman (hereafter "Kwasman"), Harry Hartman (hereafter "Hartman"), and Dennis Kirby (hereafter "Kirby") are the three persons who have been nominated as liquidators to be elected at a meeting of the shareholders of City Savings called for Tuesday, July 28, 1964, at which meeting it is proposed that a voluntary plan of liquidation of City Savings be adopted. The latter two are employees and designees of said Department of Financial Institutions and subject to its control, while Kwasman has been designated by the Board of Directors of City Savings or someone acting for its officers or directors or for some of them.

11. Plaintiffs Alexander Tcherepnin and Ming Tcherepnin, his wife, on December 12, 1963, purchased from City Savings at Chicago, Illinois, securities issued by City Savings consisting of capital shares of and a capital account interest in City Savings, for which they paid City Savings the sum of \$500.00. On January 9, 1964, they purchased additional such securities issued by City Savings for which they paid it the sum of \$3,500.00.

The other plaintiffs herein purchased from City Savings capital shares issued by and capital account interests in [fol. 6] City Savings on the respective dates listed below for which they paid City Savings the amounts listed below, as follows:

Charles Noll and Maybelle Noll: December 7, 1961, \$5,000; December 27, 1961, \$3,500; January 30, 1962, \$3,500; July 20, 1962, \$1,000; October 4, 1962, \$5,000; December 28, 1962, \$5,000; December 27, 1963, \$7,500; Total purchases \$30,500.

Harry Block and Jeanette A. Block: February 6, 1964, Total purchase \$1,041.82.

Werner D. Block, Jeanette A. Block and Harry Block: February 22, 1962, \$8,500; July 3, 1962, \$7,500; Total purchases \$16,000.

Adrian Da Prato and Peter Da Prato: February 8, 1963, \$2,597.42; July 29, 1963, \$120.80; August 29, 1963, \$65.01; Total purchases \$2,783.23. Withdrawals: August 29, 1963, \$15; March 5, 1964, \$171. Total Balance \$2597.23.

Frederick D. Wahl and Anne W. Wahl: July 17, 1962, \$3,500; October 7, 1963, \$102.15; January 10, 1964, \$265.47; June 2, 1964, \$8,422.38. Total purchases \$12,290.00. Withdrawals: April 13, 1963, \$290; April 6, 1964, \$2,000; June 5, 1964, \$1,475; Total withdrawals \$3,765. Total Balance \$8,525.

Theodore Machatka and Marie B. Machatka: August 30, 1962, \$5,000; January 6, 1964, \$1,041.19; January 13, 1964, \$2,000; April 2, 1964, \$500; Total purchases \$8,541.19.

Joseph Novak and Frances Novak: April 2, 1964, Total purchase \$500.

Marybeth Simjack: May 7, 1963, Total purchase \$5,000.

Walter R. Anderson: January 3, 1963, \$2,000; January 9, 1963, \$3,548.85; March 21, 1963, \$3,500; Total purchases [fol. 7] \$9,048.85. Withdrawals: February 6, 1964, \$5,000; Total balance \$4,048.85.

Helen K. Kellogg on January 7, 1964, \$500; on February 19, 1964, \$1,000; on February 25, 1964, \$500; Total \$2,000.

12. Said purchases were made by plaintiffs respectively pursuant to and in reliance upon printed solicitations received by them from City Savings through the United States mails.

13. Said mailed solicitations were false and misleading in violation of Section 10(b) of the Securities Exchange Act of 1934 (15 USC 78j (b)) and Rule 10b-5 of the General Rules and Regulations promulgated thereunder. Rule 10b-5 reads as follows:

"Rule 10b-5. EMPLOYMENT OF MANIPULATIVE AND DECEPTIVE DEVICES.

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange

- (1) to employ any device, scheme, or artifice to defraud,
- (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
- (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

14. Section 29(b) of the Securities Exchange Act of 1934 (15 USC Section 78cc(b)) provides in part:

[fol. 8] "(b) . . . every contract . . . heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this title or any rule or regulation thereunder, shall be void (1) as regards the rights of any person, who in violation of any such provision, rule, or regulation, shall have made . . . any such contract . . ."

15. By virtue of the provisions of said Section 29(b) of said Act, the sale of said securities by City Savings to plaintiffs and the purchase by plaintiffs of said securities from City Savings was and is void, and any and all acts and things done pursuant to said sale and purchase were and are unlawful, illegal, and void, and the plaintiffs are entitled to rescind any such sales and purchases and to have the purchase prices refunded to them, together with interest at the rate of 5% per annum from the date of said respective purchases, for the reasons hereinafter set forth.

16. For many years prior to 1957, as well as since, and continuing to the present time, City Savings has been dominated and controlled by Mensik who has determined the policies and activities of City Savings in all important respects. At all times since about 1943 he has been the principal executive officer of City Savings.

17. Beginning in the year 1957, Defendant Mensik became the subject of a substantial flow of adverse publicity which has continued from time to time up to the present. This publicity originally involved the Orville Hodge scandal and defendant's suspect financial involvements with Hodge. Among other things, there were questions as to whether in return for financial favors, Hodge, as Auditor of Public Accounts of the State of Illinois, unlawfully or in some other illicit manner, favored Mensik with preferred treat-

ment in granting charters for two new reserve guarantee [fol. 9] savings and loan associations issued pursuant to a then recent amendment to the Illinois Savings and Loan Act permitting for the first time the issuance of such charters. Subsequently, the publicity related to Mensik's embroilment with the then Auditor of Public Accounts of the State of Illinois, successor to Hodge, concerning the manner in which Mensik had conducted his several savings and loan associations in the City of Chicago, the publicity covering charges of self-dealing while in a fiduciary capacity, as well as alleged mismanagement. Thereafter the publicity related to an investigation by United States postal inspectors and his criminal indictment in 1959 at Baltimore, Maryland, on charges of mail fraud involving savings and loan associations, his trial under that indictment, his subsequent reindictment in 1963, and his ultimate conviction on mail fraud charges, from which he is now appealing. There was also publicity concerning his alleged involvement with the International Guaranty and Insurance Company, of Tangiers, Morocco, which it was alleged, on a limited capitalization of less than one million dollars, had insured deposits of savings and loan associations in four or five states, totalling more than sixty-five million dollars. The publicity further related to charges that the principal assets of that insurance company consisted of a group of second mortgages with a maximum value of \$600,000, acquired from a building company in which Mensik was interested. It was further alleged in such publicity that the savings and loan associations dominated and controlled by Mensik, or one of such associations, had made approximately three-fourths of its loans (\$6,300,000 out of \$8,400,000) to three or four building or construction companies controlled by Mensik, members of [fol. 10] his family, or close business associates. Further, such publicity related to charges that Mensik, owned and operated a company which operated safety deposit vaults and another company which operated an insurance agency which made their profits primarily from the patronage

of depositor shareholders in one or more of Mensik's savings and loan associations, the insurance premiums being derived primarily from insurance on properties of borrowers from Mensik's savings and loan associations. The publicity indicated facts warranting the possible conclusion that the operation of such safe deposit vaults and such insurance agency by Mensik were wrongful deprivations of corporate opportunities by Mensik which in fact belonged to one or more of such associations. The publicity further indicated that the rent charged by one or more of said associations to said privately owned companies of Mensik was grossly inadequate and, further that employees of the safe deposit company and the insurance agency, or persons performing services for them, were wrongfully being paid for such services by one or more of said publicly held savings and loan associations. The publicity further related to a claim by the United States Government in September, 1963, against Hodge for back income taxes in the amount of \$2,700,000, of which the Internal Revenue Service listed \$205,000 which it said Hodge received in unreported income from Mensik in 1955. In February, 1964, there was further publicity to the effect that the United States Court of Appeals had held Mensik liable for \$301,533 in back income taxes, and that the United States Tax Court had previously held that Mensik had not reported kickbacks from a building company that remodeled the savings and loan association headquarters. Further publicity in March, 1964, [fol. 11] reported that Mensik was sentenced to five years in prison and fined \$3,000 by the Federal Court in Richmond, Virginia, for savings and loan mail fraud, which sentence is being appealed, as above stated.

18. Whether or not any or all of such publicity was true or false, it was apparent from early 1957 and continuously thereafter that the name of defendant Mensik was not likely to engender trust and confidence in the minds of prospective depositor-shareholders sought by City Savings, and that it was unlikely that members of the

public would entrust part or all of their life savings to a savings and loan association headed by Mensik.

19. After Mensik's name began to be widely and unfavorably publicized, starting in about 1959 or 1960 and continuing thereafter to the present time, Mensik and the then Board of Directors of City Savings and each of the directors and officers of City Savings from time to time thereafter in office, entered into and carried out a conspiracy with each other to conceal from the public and prospective depositor-shareholders that Mensik was in any way connected with City Savings as an officer or director, and from about 1959 or 1960 to the present time, contrary to the practice of City Savings theretofore, Mensik's name has been deliberately omitted from all literature issued by City Savings, including all of the flamboyant advertising regularly issued by City Savings and sent through the United States mails on a broadcast basis throughout various states of the United States in City Savings' efforts to solicit new depositor-shareholders and additional purchases of securities by existing depositor-shareholders. This deliberate concealment of Mensik's name and the fact that City Savings was at all times under the domination and control of Mensik as its President, Director, and Chief [fol. 12]. Executive Officer, constituted the concealment and omission of material facts which, if disclosed to plaintiffs and substantially all of the other new depositor-shareholders who purchased the securities of City Savings as a result of said false and misleading mail solicitations, would have caused them to refrain from purchasing any securities issued by City Savings or paying any monies to it for depositor-shareholder capital accounts.

20. The sales literature sent out by City Savings throughout various states of the United States, through the United States mails, to plaintiffs and others, offered expensive premiums, such as TV sets, typewriters, Polaroid cameras, luggage, radios, hi-fi sets, and other items, contingent upon the size of each new purchase of depositor-

shareholder accounts or additional investment in the capital of City Savings by those already investors. Although such advertising was false and misleading in that it spoke of the financial strength of City Savings and advanced reasons as to the desirability of purchasing the securities of City Savings, each of such circulars mailed after 1957 omitted to state the very material facts that City Savings contrary to the preponderant custom of both Federal and State chartered savings and loan associations to have insurance, had been unable to arrange for insurance of depositor-shareholder accounts with the Federal Agency providing such insurance to other associations, had in fact been rejected by the Federal Home Loan Bank Board when it did apply for such insurance because of City Savings' unsafe financial policies and unsafe management, had taken out a one-year policy with the International Guaranty and Insurance Company, of Tangiers, Morocco, and that such latter insurance had not been renewed by it, that said insurance company was so improperly financed and managed [fol. 13] that it had been subsequently liquidated by the State of California (where its principal office was located) and that, as a result, any investor-depositor who drew his money out of a Federally insured bank or savings and loan association to purchase depositor shares of City Savings would be uninsured thereafter as would be the situation of any other purchaser of such securities. In addition, such material facts were not disclosed to the purchasers of such securities of City Savings, including plaintiffs, at any time prior to the time City Savings closed its doors on or about June 30, 1964, on approximately which date, plaintiffs allege on information and belief, the Director of Financial Institutions of the State of Illinois took custody of its assets. Only after said closing did plaintiffs learn that Mensik was and is an officer director and in control of City Savings.

21. At all times since about 1957, City Savings has had outstanding commitments involving cash disbursements in connection with construction commitments, loans and other matters, which far exceeded its cash resources on hand. As

a result, by action of its Board of Directors, City Savings had in effect limitations as to the amount of money which many of its investors could withdraw in cash from their withdrawable capital depositor share accounts in any one year. At the present time, there are still about twelve million dollars of such withdrawable capital accounts on a "rotation" basis, meaning, on a limited annual withdrawal basis, which represent shareholder-depositor accounts in existence in 1957. In 1959, the legislature of the State of Illinois passed a law which appears as subparagraph (h) of Section 4-13 of the Illinois Savings & Loan Act (Smith-Hurd Ill. Rev. Stats. Ch. 32, Sec. 773-(4-13) (h)): Said [fol. 14] Act permits a savings and loan association which is on a rotation basis, to sell new investments in savings-shareholder accounts, provided that the new deposits are withdrawable at will. Despite said proviso and in violation thereof, City Savings since 1959 has sold new depositor-shareholder investors' accounts on a restricted withdrawal basis, without compliance with any provision of the Savings & Loan Act necessary to permit new limited withdrawal capital investments, and has failed in all its advertising literature so sent through the mails, or otherwise, to disclose to prospective new purchasers of its securities, that it was on a limited withdrawal basis as to earlier accounts. These were material omissions causing the mailed circulars to be false and misleading and plaintiffs and the other new depositor-shareholders were misled in reliance thereon to purchase such securities issued by City Savings. Had such restrictions not been imposed by the Board of Directors and Mensik, the earlier investors, who then knew about Mensik's reputation to a greater or lesser extent, would have withdrawn all of their funds had they been able to do so.

22. The omission to state the material facts alleged above, which facts were necessary to be stated in order to make the statements made in said advertising circulars which served as the prospectus for the sale of said securities, in the light of the circumstances under which they

were made, not misleading, constitutes a violation by City Savings and the defendant officers and directors of City Savings of Section 10b of the Securities Exchange Act of 1934 (USC 78j(b)) and of Rule 10b-5 of the General Rules and Regulations under said Act.

23. As a result of the unlawful acts of defendant, City Savings, its officers and directors as above stated, more [fol. 15] than 5,000 investors have purchased securities of City Savings since July 23, 1959 in reliance upon such false and misleading representations sent to them through the United States mails by City Savings, each of which mailings omitted to state material facts as above alleged. These persons constitute a class and there is a common question of law and fact affecting the several rights of said persons, including plaintiffs, and common relief is sought hereby. Said persons are so numerous as to make it impractical to bring them all before the Court and plaintiffs will fairly insure the adequate representation of all of said persons. Plaintiffs bring this action on behalf of themselves and as a class action for and on behalf of said numerous other persons pursuant to Rule 23 of the Federal Rules of Civil Procedure. Plaintiffs state that the claims of plaintiffs and of all such other persons similarly situated aggregate between fifteen and twenty million dollars.

24. The assets of City Savings are in the custody of Defendant Joseph E. Knight as Director of the Department of Financial Institutions of the State of Illinois and of Defendant Justin Hulman, supervisor of the Savings and Loan Division of said Department. Defendant Mensik claims to hold valid proxies to vote approximately 90% of the outstanding shares of City Savings at the meeting of its shareholders to be held on July 28, 1964, and will vote said proxies in favor of a resolution to voluntarily liquidate City Savings pursuant to a voluntary plan of liquidation of City Savings proposed by Defendant Knight. Defendant Mensik further will vote the said proxies, which he claims to hold, in favor of the election of Defendants

Kwasman, Hartman, and Kirby as liquidators of City Savings.

[fol. 16] Wherefore plaintiffs pray:

1) For the entry of an order finding that all sales of depositor-withdrawable capital shares by City Savings since July 23, 1959 were and are void and that the purchasers of such securities are creditors of City Savings entitled to receive repayment of the purchase price paid for their respective depositor-withdrawable capital shares, including their depositor accounts, in the respective amounts paid by them for such securities, with interest thereon at the rate of 5% per annum from the respective dates they respectively purchased said securities from City Savings and paid City Savings therefor, less any amounts previously paid to them respectively, together with reasonable attorney's fees and costs of this suit.

2) For the entry of judgments in favor of plaintiffs and all other respective purchasers of such securities in the aggregate principal amount of twenty million dollars (\$20,000,000.00), with interest on the judgment of each purchaser at five (5%) per centum per annum from the respective dates of purchase by each such purchaser who bought and paid for such securities on or after July 24, 1959.

3) That this Court temporarily and permanently restrain and enjoin each and all of the defendants from paying out any amounts of the assets or proceeds of assets of City Savings to any shareholder-depositor who purchased his depositor-shareholder account from City Savings prior to July 24, 1959, without first paying to plaintiffs and all other purchasers of depositor-shareholder accounts who made such purchases on or after July 24, 1959, the full refund of the purchase prices paid by them for such securities, plus such [fol. 17] interest. In the event that any of the defendants pay any amount to any depositor-shareholder for

shares acquired prior to July 24, 1959, without first paying in full those who acquired their depositor-shares on that date or thereafter, to the extent that any such payment is made out of assets of City Savings or the proceeds thereof, this Court enter personal judgment against the defendants and each of them and against the sureties on their respective official bonds, if any, heretofore or hereafter given by them for the faithful performance of their official duties with respect to the assets of City Savings.

4) That this Court order that the City Savings records of depositor-shareholder accounts disclosing each depositor-shareholder who purchased his or her securities of City Savings on or after July 24, 1964, stand as the proofs of claim of such depositor-shareholders as creditors of City Savings without the need for any other or further proofs of claim by any of them.

5) That this Court sequester out of the proceeds of this action and order paid to the attorneys for plaintiffs such amount as this Court finds to be reasonable as attorneys' fees for their services herein, commensurate with the nature, magnitude, and results of such services in this proceeding.

IN UNITED STATES DISTRICT COURT

MOTION OF DEFENDANTS DENNIS KIRBY, LOUIS KWASMAN, HARRY HARTMAN AND CITY SAVINGS ASSOCIATION TO STRIKE THE COMPLAINT AND TO DISMISS THE CAUSE OF ACTION OR, IN THE ALTERNATIVE, TO MAKE THE COMPLAINT MORE DEFINITE AND CERTAIN—Filed November 20, 1964

[fol.18]. Defendants Dennis Kirby, Louis Kwasman, Harry Hartman and City Savings Association move the Court as follows:

1. To dismiss the action because the complaint fails to state a claim against the defendants upon which relief can be granted.
2. To dismiss the action because the court lacks jurisdiction over the subject matter.
3. To dismiss the action because the complaint fails to state a cause of action under the sections of the Securities Exchange Act of 1934, as amended, under any of the provisions of said act referred to in the complaint or under any other provisions of said act or any of the rules in force promulgated thereunder.
4. To dismiss the action for the reason that the provisions of the Securities Exchange Act of 1934, as amended, do not apply to the withdrawable shares of the defendant City Savings Association, which is a savings and loan association organized under the Illinois Savings and Loan Act (Chapter 32 Ill. Rev. Stat., Section 701 et seq.).
5. To dismiss the complaint for the reason that it fails to state properly a class action within the provisions of Rule 23 (a) of the Federal Rules of Civil Procedure.

IN UNITED STATES DISTRICT COURT

MOTION OF DEFENDANTS KNIGHT AND HULMAN TO DISMISS,
STRIKE OR MAKE MORE DEFINITE—Filed November 20,
1964

Now comes the defendants, Knight and Hulman, by their attorney, William G. Clark, Attorney General of the State of Illinois, and moves this honorable Court as follows:

1. To dismiss the complaint previously filed herein;
2. To strike the complaint previously filed herein;
3. To order the plaintiffs to make their complaint more definite.

[fol. 19] As grounds for the aforementioned Motion, the defendants, Knight and Hulman state as follows:

1. The alleged cause of action set forth in the complaint is barred by the Statute of Limitations.

2. The complaint should be dismissed, because the relief prayed for is improper.

3. The defendants named in the complaint are improper and should be dismissed.

4. The complaint does not state a cause of action.

5. Section 78q of the Securities Exchange Act of 1934 does not apply to the withdrawable share of a savings and loan association organized under the laws of the State of Illinois.

[fol. 19a]

IN UNITED STATES DISTRICT COURT

MOTION TO STRIKE THE COMPLAINT AND DISMISS THE CAUSE OF ACTION—Filed November 20, 1964

Now come the defendants, Robert Franz, Stanley Pasko, Robert M. Kramer, C. Oran Mensik, Joseph Talarico and Gloria Mensik Sprincz, by their duly authorized attorneys, and move this Court to strike the complaint of the [fol. 19b] plaintiffs and dismiss the cause of action for the following reasons:

1. The complaint fails to state a cause of action within the terms of Section 10 (b) of the Securities Exchange Act of 1934 (15 U.S.C. §78j) and Rule 10B-5 promulgated thereunder because:

A. The plaintiffs fail to state facts upon which relief may be granted, and;

B. Said statutory sections do not apply to the withdrawable deposits in a savings and loan associ-

ation organized under the law of the State of Illinois.

2. The complaint fails properly to allege a class action within the provisions of Rule 23 (a) of the Federal Rules of Civil Procedure.

3. The complaint fails to identify with particularity the "sale literature" relied upon by plaintiffs in depositing their money in savings accounts with City Savings Association, which information is required to be set forth.

George S. Lavin, William P. Rosenthal, Leonard Sheanfield, Henry M. Morris, Norman L. Rothenbaum, Attorneys for certain defendants, 110 South Dearborn Street, Chicago, Illinois 60603, CEntral 6-5622.

[fol. 19]

IN UNITED STATES DISTRICT COURT

ORDER—January 17, 1966

Defendants motions to dismiss the complaint or, in the alternative, to make the complaint more definite and certain are *denied*. Judge Campbell.

[fol. 21]

IN UNITED STATES DISTRICT COURT

ANSWER OF CITY SAVINGS ASSOCIATION, LOUIS KWASMAN, HARRY HARTMAN AND DENNIS KIRBY—Filed February 3, 1966

City Savings Association, Louis Kwasman, Harry Hartman and Dennis Kirby, defendants, for answer to the complaint of plaintiffs, state:

1. Defendants deny the allegations of paragraph 1 and specifically deny that this Court has jurisdiction under any statute.

2. Defendants admit that City Savings Association is a savings and loan association organized under the laws of the State of Illinois, but aver that on July 28, 1964, City Savings Association adopted a Plan of Voluntary Liquidation in accordance with the provisions of Article 9 of the Illinois Savings and Loan Act, Ill. Rev. Stat. ch. 32 § 901 et seq. (1965). Defendants Louis Kwasman, Harry Hartman and Dennis Kirby were duly elected and are acting as liquidators under said Plan of Voluntary Liquidation. Said Plan of Voluntary Liquidation was [fol. 22] approved by the Director of the Department of Financial Institutions of the State of Illinois, by a certificate duly recorded on August 7, 1964, in the office of the Recorder of Deeds of Cook County, Illinois as Document No. 19208434, whereupon said Plan of Voluntary Liquidation became effective as provided by § 9-4 of the said Illinois Savings and Loan Act. These defendants deny that City Savings Association issued or sold any securities to plaintiffs.

3. These defendants admit that at one time C. Oran Mensik was director, president, and principal executive officer of City Savings Association. These defendants are without knowledge or information sufficient to form a belief as to the truth of the allegations that Mensik was director, president, and principal executive officer during all times material. Defendants deny that Mensik is now a director, president, or principal executive officer of City Savings Association.

4-8. These defendants admit that Robert M. Kramer, Stanley Pasko, Joseph Talarico, Jr., Gloria Mensik Sprincz, Robert Franz, and Herbert J. Hoover held at one time the offices or positions in City Savings Association alleged by plaintiffs, but deny that they hold said offices, or any office, at the present time. These defendants aver, on information and belief, that Herbert J. Hoover is now deceased.

9. These defendants admit that defendant Joseph E. Knight is Director of the Department of Financial Institutions of the State of Illinois and that prior to August 1, 1965 defendant Justin Hulman was the Supervisor of the Savings and Loan Division of said department. These defendants aver that by virtue of the provisions of Ill. Rev. Stat. ch. 32, § 841 et seq. (1965), which became effective August 1, 1965, the Illinois Savings and Loan Act was amended whereby an agency of the State of Illinois known as the Office of the Commissioner of Savings and Loan Associations was created and defendant Justin Hulman was duly appointed, qualified, and is now acting as Commissioner thereof. These defendants aver that the Office of the Commissioner of Savings and Loan Associations now has the same relationship to City Savings Association as the Director of Financial Institutions formerly had prior to the effective date of said amendatory Act.

10. These defendants admit that defendants Kwasman, Hartman, and Kirby were duly nominated as Liquidators of City Savings Association under a proposed Plan of Voluntary Liquidation. These defendants aver that said defendants Kwasman, Hartman, and Kirby were duly elected as liquidators at a meeting of the shareholders of City Savings Association duly held on July 28, 1964, at which meeting a Plan of Voluntary Liquidation for City Savings Association was duly adopted in accordance with the provisions of Article 9 of the Illinois Savings and Loan Act. These defendants admit that defendants Hartman and Kirby are employees of the State of Illinois but deny the remaining allegations of paragraph 10.

11. These defendants admit that the plaintiffs named in paragraph 11 made deposits at City Savings Association in the amounts set forth and on the dates indicated in paragraph 11. These defendants deny the remaining allegations of paragraph 11 and specifically deny that the plaintiffs indicated, or any other persons, made purchases of securities from City Savings Association.

12. These defendants deny that any purchases whatever were made by plaintiffs or any of them. These defendants lack information sufficient to form a belief as to the truth of the allegations as to the motivation for plaintiffs' activities.

13. These defendants admit that quoted in paragraph 13 are excerpts from Rule 10b-5 of the General Rules and Regulations promulgated under § 10(b) of the Securities Exchange Act of 1934. These defendants deny the remaining allegations of paragraph 13.

14. These defendants admit the allegations of paragraph 14.

15. These defendants deny the allegations of paragraph 15.

16. These defendants admit the allegations of paragraph 16, except that they aver that Mensik's domination and control of City Savings Association ceased temporarily during a period in 1957 when City Savings Association was placed under the custody and control of the Auditor of Public Accounts of the State of Illinois, and ceased permanently on or about June 30, 1964 when City Savings Association was again placed under the custody of the Director of the Department of Financial Institutions of the State of Illinois, whose functions have since been assumed by the Commissioner of Savings and Loan Associations of the State of Illinois as of August 1, 1965.

17. These defendants lack information sufficient to form a belief as to the truth of the allegations of paragraph 17.

18. These defendants lack information sufficient to form a belief as to the truth of the allegations of paragraph 18.

19. These defendants lack information sufficient to form a belief as to the truth of the allegations of paragraph 19 and specifically lack information sufficient to form a belief [fol. 25] as to the truth of the allegation that Mensik's

name was concealed and as to the allegation of the effect disclosure of Mensik's name would have had.

20. These defendants lack information sufficient to form a belief as to the truth of the allegations pertaining to the sales literature purportedly sent out on behalf of City Savings Association and the representations or omissions contained therein. These defendants admit that the Director of the Department of Financial Institutions of the State of Illinois took custody of the assets of City Savings Association on or about June 30, 1964. These defendants lack information sufficient to form a belief as to the truth of the allegations as to the date that plaintiffs learned of Mensik's connection with City Savings Association.

21. For answer to the allegations of paragraph 21, these defendants deny that City Savings Association had commitments as alleged in plaintiffs' complaint, and deny that any commitments purporting to have been made by City Savings Association were, in fact, binding obligations. These defendants admit that at one time there was a limitation imposed by the Board of Directors of City Savings Association as to the amount of money which its depositors could withdraw. These defendants deny that there are \$12,000,000 of withdrawable capital on a "rotation" basis, or on any other withdrawable basis, for the reason that the City Savings Association is now in liquidation and no withdrawals have been permitted. These defendants admit that the Savings and Loan Act (Smith-Hurd, Ill. Rev. Stats. ch. 32 §901 et seq.) was revised. These defendants deny the remaining allegations of paragraph 21. not herein specifically admitted.

22. These defendants deny the allegations of paragraph 22.

[fol. 26] 23. These defendants deny the allegations of paragraph 23.

24. The allegations of paragraph 24 are now moot. Defendant City Savings Association is in the process of voluntary liquidation as alleged in paragraph 2 above.

25. For a further and affirmative defense these defendants aver that plaintiffs' complaint fails to state a cause of action or to state a claim upon which relief can be granted in that the deposits made by plaintiffs do not constitute a security within the meaning and intent of Section 29(b) of the Securities Exchange Act of 1934 [15 U.S.C. § 78cc(b)] or of Section 10(b) of the Securities Exchange Act of 1934 [15 U.S.C. § 78j(b)], and in that Section 29(b) of the Securities Exchange Act of 1934 does not provide a remedy to these plaintiffs under the circumstances as set forth in the complaint.

26. For a further and affirmative defense these defendants aver that plaintiffs do not represent a class, that they do not plead the requisites of a class action, and further, that plaintiffs have failed to comply with the provisions of Rule 23 of the Federal Rules of Civil Procedure in that (a) the parties are not so numerous as to make it impractical to bring them all before the Court, but on the contrary aver by intervention, or otherwise, an overwhelming preponderance of the depositors have become parties to this action, and (b) there is no common question of law and fact affecting the several rights of the parties, but on the contrary the rights of each of the plaintiffs are separate and distinct, depending upon the so-called representations made to each plaintiff and his reliance and right to rely thereupon. Accordingly, plaintiffs represent only themselves.

[fol. 27] 27. For a further and affirmative defense these defendants aver that defendant City Savings Association is now in the process of voluntary liquidation under the Illinois Savings and Loan Act and was subject to the supervision and direction of the Director of the Department of Financial Institutions of the State of Illinois until August

1, 1965, and thereafter has been subject to the supervision and examination of the Commissioner of Savings and Loan Associations of the State of Illinois. The State of Illinois, acting through its agencies mentioned above, has exclusive jurisdiction over all matters pertaining to the liquidation, including the claims, if any, of plaintiffs herein. Pursuant to the provisions of Section 9-7 of the Illinois Savings and Loan Act, plaintiffs' claims are required to be presented initially to the liquidators, whose function, among others, is to determine the relative rights of creditors and depositors. Under that Section, no depositor shall be given a preference by any method until after the liquidators have made a determination as to the relative priorities. The purpose of plaintiffs' claims herein is to give them a preference over other depositors. Because the plaintiffs have not presented their claims to the liquidators; and because the liquidators have not made a final determination as to the relative priorities, the plaintiffs have not suffered any injury and their resort to this Court is untimely and premature. Plaintiffs have failed to exhaust their administrative remedies and their action should be dismissed.

28. For a further and affirmative defense these defendants aver that plaintiffs are guilty of laches.

29. For a further and affirmative defense these defendants aver that plaintiffs' claims are barred by the statute of limitations.

[fol. 28] Wherefore, defendants City Savings Association, Louis Kwasman, Harry Hartman and Dennis Kirby pray that the complaint of plaintiffs be dismissed and that they have judgment for their costs.

IN UNITED STATES DISTRICT COURT

ANSWER OF DEFENDANTS KNIGHT AND HULMAN—Filed
February 3, 1966

Now comes Defendants, Joseph E. Knight, Director of Department of Financial Institutions of the State of Illinois and Justin Hulman, Supervisor Savings and Loan Division of said Department by William G. Clark, Attorney General of the State of Illinois, their attorney and make Answer to Plaintiffs' complaint filed herein, as follows:

1. Deny each and every allegation in Paragraph "1" except admit the existence of such Statute and that plaintiffs purport to base the jurisdiction of this court upon such Statute, although deny that this court has jurisdiction under any statute.

2. Deny each and every allegation of the last sentence of Paragraph "2" except admit the remaining allegation of said paragraph. In further answer defendants deny that any securities are involved in this claim within the meaning and intent of the Securities Exchange Act of 1934 (15 USC § 78aa) and SEC Rules thereunder.

3. Deny knowledge or information sufficient to form a belief as to each and every allegation in Paragraphs "3," "4," "5," "6," "7," and "8," except admit that the persons listed in said paragraphs were at one time or other connected with City Savings Association.

4. Admit the allegations in paragraph "9" as of the date of filing the complaint herein but allege that presently the official capacities of defendants Knight and Hulman have been reclassified by Illinois law regarding savings and loan associations in so far as defendant Hulman [fol. 29] is the Commissioner of Savings and Loan Association of the State of Illinois and defendant Knight is presently divested of any authority or control of savings and loan associations which are under the State of Illinois supervision.

5. Deny each and every allegation of Paragraph "10" except admit that defendants Kwasman, Hartman and Kirby were nominated as liquidators of City Savings Association under a plan of voluntary liquidation. In further answer defendants Kwasman, Hartman and Kirby were duly elected as liquidators at a meeting of depositors of City Savings Association held on July 28, 1964 (which occurred subsequent to the filing of the complaint herein) at which meeting a plan of voluntary liquidation for City Savings Association was duly adopted in accordance with the provisions of the Illinois Savings and Loan Act, Article 9. Further answering defendants Hartman and Kirby were employees of the Illinois Department of Financial Institutions but are now employed by the Illinois Office of the Commissioner of Savings and Loans Associations.

6. Deny knowledge or information sufficient to form a belief as to each and every allegation in paragraph "11" and further allege that no securities are involved within the meaning and intent of the Securities Exchange Act of 1934 (15 USC 78aa) and SEC Rules thereunder.

7. Deny knowledge or information sufficient to form a belief as to each and every allegation in paragraphs "12," "17," "18," "19," and "23".

8. Deny knowledge or information sufficient to form a belief as to each and every allegation in paragraph "13" and "14" except admit the existence and substance of Rule 10 (b)-5 and Section 29 (b) of the Section 29 (b) of the [fol. 30] Securities Exchange Act of 1934 (15 USC Section 78cc (b)) but such rule and statutory provision have no application to defendants herein.

9. Deny knowledge or information sufficient to form a belief as to each and every allegation in paragraph "15". Further answering allege that no securities are involved within the meaning and intent of the Securities Exchange Act of 1934 (15 USC 78aa) and SEC Rules thereunder.

10. Deny knowledge or information sufficient to form a belief as to each and every allegation of paragraph "16" except admit on information and belief that defendant Mensik participated in the operation of City Savings Association.

11. Deny knowledge or information sufficient to form a belief as to each and every allegation in paragraph "20" except on information and belief admit that City Savings Association had been denied insurance of accounts by the Federal Home Loan Bank Board and that defendant Knight, Director of Financial Institutions of the State of Illinois took custody of City Savings Association on or about June 30, 1964.

12. Deny knowledge or information sufficient to form a belief as to each and every allegation of paragraph "21". Further answering admits that at one time there was a limitation imposed by the Board of Directors of City Savings Association as to the amount of money which its depositors could withdraw. In further answer deny that there are \$12,000,000 of withdrawable capital on a "rotation" basis, or on any other withdrawable basis, for the reason that the City Savings Association is now in liquidation and no withdrawals have been permitted. These defendants admit that the Savings and Loan Act (Smith-[fol. 31] Hurd, Ill. Rev. Stats. Chapter 32, Section 901 *et seq.*) was revised.

13. Deny each and every allegation of paragraph "22".

14. Deny knowledge or information sufficient to form a belief as to each and every allegation in paragraph "24" except admit the first sentence of said paragraph, but only as to defendant Hulman as of this time since in further answer defendant Knight, who formerly controlled the Savings and Loan Division of the Illinois Department of Financial Institutions no longer has such authority under Illinois law. On information and belief defendant Mensik, had a substantial number of proxies and voted said

proxies in favor of the plan for voluntary liquidation after the filing of this complaint herein.

**First Affirmative Defense of Defendants
Knight and Hulman**

15. For a first affirmative defense allege the complaint fails to state a claim against defendants upon which relief can be granted.

**Second Affirmative Defense of Defendants
Knight and Hulman**

16. For a second affirmative defense allege that this court lacks jurisdiction over the subject matter of this alleged claim since there is no claim under any federal statute.

**Third Affirmative Defense of Defendants
Knight and Hulman**

17. For a third affirmative defense allege that this court lacks jurisdiction over the person of these defendants since they are being sued in their official capacity as a state officer and is therefore a claim against the State of Illinois which is barred.

[fol. 32]

**Fourth Affirmative Defense of Defendants
Knight and Hulman**

18. For a fourth affirmative defense allege that defendants are not proper parties to this claim and cannot be sued or made defendants in this alleged claim.

**Fifth Affirmative Defense of Defendants
Knight and Hulman**

19. For a fifth affirmative defense alleged that the alleged claim is barred by the Statute of Limitations.

Sixth Affirmative Defense of Defendants
Knight and Hulman

20. For a sixth affirmative defense allege that the alleged claim is barred by laches.

Seventh Affirmative Defense of Defendants
Knight and Hulman

21. For a seventh affirmative defense allege that the plaintiffs have brought this claim in bad faith and without doing equity but yet invoking this court's equitable powers and are therefore estopped.

Eighth Affirmative Defense of Defendants
Knight and Hulman

22. For an eighth affirmative defense allege that the relief prayed for in the complaint is not supported by any allegations against these defendants.

Ninth Affirmative Defense of Defendants
Knight and Hulman

23. On information and belief for a ninth affirmative defense allege that the alleged claim is barred since plaintiffs had their proxies voted in favor of the plan for voluntary liquidation and cannot seek a preferred position over other depositors.

[fol. 33]

Tenth Affirmative Defense of Defendants
Knight and Hulman

24. On information and belief for a tenth affirmative defense allege that plaintiffs by having their proxies voted in favor of the plan for voluntary liquidation have ratified and affirmed the acts of defendants which are complained of in the complaint.

Eleventh Affirmative Defense of Defendants
Knight and Hulman

25. On information and belief for an eleventh affirmative defense allege that plaintiffs do not represent a class, that they do not plead the requisites of a class action, and further, that plaintiffs have failed to comply with the provisions of Rule 23 of the Federal Rules of Civil Procedure in that (a) the parties are not so numerous as to make it impractical to bring them all before the Court, but on the contrary allege by intervention, or otherwise, an overwhelming preponderance of the depositors have become parties to this action, and (b) there is no common question of law and fact affecting the several rights of the parties, but on the contrary the rights of each of the plaintiffs are separate and distinct, depending upon the so-called representations made to each plaintiff and his reliance and right to rely thereupon. Accordingly plaintiffs represent only themselves.

Wherefore, Defendant Knight and Hulman demand judgment in their favor and against plaintiffs and that the complaint be dismissed together with costs, expenses and disbursements of this action to be paid for by plaintiffs.

[fol. 34]

IN UNITED STATES DISTRICT COURT

MEMORANDUM AND ORDER—March 22, 1966

Plaintiffs are presently before the court on a motion seeking the appointment of a receiver.

Since I assumed jurisdiction in this case on January 17, 1966 I have had the benefit of extensive oral argument by the many able attorneys representing the various parties. Additional briefs and pleadings, in the main addressed to the present motion for the appointment of a receiver, have been filed and I have had the opportunity to review ex-

tensively the Peat, Marwick, Mitchell and Company April 30, 1964 Audit report, which prior to my order of February 21, 1966 (Transcript of Proceedings, February 21, 1966, p. 24) was filed of record but impounded. On the basis of this exhaustive review of what conservatively can be characterized as a most complex and extensive matter—both factually and legally—I make the following observations in deciding the pending motion.

When initially making my decision to assume jurisdiction over this case I was faced with deciding what I acknowledged to be a difficult, far reaching and close legal issue of first impression. I refer to the issue of whether or not Illinois savings and loan depositors or investors enter into an investment contract and in effect are purchasers of securities within the meaning and provisions of the Exchange Act. 15 U.S.C. 78a, *et seq.*

Normally, when making such an important interlocutory decision without the benefit of some prior judicial authorities, preferably from our own Seventh Circuit, I have looked with favor upon motions requesting a §1292(b) interlocutory appeal. (*Radiant Burners Inc. v. American Gas Association et al*, 207 F. Supp. 771 and 209 F. Supp. 321, Rev. in 320 F.2d 314, cert. den. 375 U.S. 929.) However, in the instant case I denied defendants' motions requesting [fol. 35] permission to file such an interlocutory appeal. In denying defendants' motions I explained that my main concern was the plight of the individual investors. (Transcript of Proceedings, January 21, 1966, pp. 17-20)

Then, as now, their protection and the expeditious resolution of all of the issues presently standing in the way of a final and fair total liquidation of City Savings and Loan Association was my objective. I was then impressed, as I am now even more impressed, with what appears to be a confusion in efforts, possible conflicting interests, and the possible resulting subjugating of investors' claims to the interests of others. A final and total resolution and payment of investors claims appears long overdue.

Plaintiffs, certainly not by design, by their present motion for appointment of a receiver place an additional burden and obstacle in the way of my expediting this matter. The mere granting of the motion and appointment of a receiver—standing alone—would, of course, cause no additional delay, for that matter I believe the converse would result; the resolution of the cause would most probably be expedited. However, the granting of the motion would necessarily, and quite properly, serve to permit defendants the interlocutory appeal heretofore denied them. (Title 28 U.S.C.A. §1292(a)(2)) The delay I sought to preclude with thus prove unavoidable.

Accepting this necessary result, delay, albeit procedurally proper, is inevitable. The main cause for my denying defendants' earlier motions for interlocutory appeal is therefore no longer controlling.

A motion in Federal Court for the appointment of a receiver should be granted only under the extremest of [fol. 36] circumstances. In *Connolly v. Gishwiller*, 162 F2d 428 our Seventh Circuit Court of Appeals, although affirming the lower court's appointment of a receiver stated: "It is true, of course, the power to appoint a Receiver is a drastic, harsh and dangerous one and should be exercised with care and caution". (*Connolly* p. 435) See also *Mintzer v. Arthur L. Wright Co.*, 263 F2d 823; *Chambers v. Blickly Ford Sales, Inc.*, 313 F2d 252.

Also, where as here, state law provides adequate means for affording sufficient protection of assets, federal courts should be most hesitant to assert themselves by way of receivership. *Pennsylvania v. Williams*, 294 U.S. 176; *Fulia v. Warranty Bldg. and Loan Assn.*, 5 F. Supp. 952.

Plaintiffs' complaint, briefs and most importantly their affidavits allege nothing less than fraud on the part of the present liquidators, those over whom or in lieu of a court appointed receiver would act. On the basis of plaintiff's allegations the present liquidators are either corrupt, inefficient or both. To this extent the circumstances here

might be distinguished from *Pennsylvania v. Williams* cited above. However, as is most often the case, these allegations are for the most part general and not specific. Although possibly susceptible of proof at an extended hearing or trial, these general allegations do not warrant my granting the extraordinary relief sought, especially where as here I am in the first instance proceeding upon legally tenuous jurisdictional grounds. Rather than compound the legal uncertainty of my rulings I must deny the present motion for appointment of a receiver. As already stated this determination is further indicated by the necessary elimination of what I expressed to have been the overriding salutary purpose of my prior rulings; the expeditious resolution of the investors claims.

[fol. 37] Accordingly, I deny plaintiffs' motion for the appointment of a receiver. Recognizing the consequences of this ruling I do hereby certify that my order denying this motion "... involves a controlling question of law as to which there is substantial ground for difference of opinion and that an immediate appeal from the order may materially advance the ultimate termination of the litigation ...". (Title 28 U.S.C. §1294(b))

Further, on my own motion and for the reasons detailed above I now certify that my Order of January 17, 1966 assuming jurisdiction over this case and in effect holding that withdrawable capital shares in a savings and loan association are securities within the meaning of the Exchange Act also "... involves a controlling question of law as to which there is substantial ground for difference of opinion and that an immediate appeal from the order may materially advance the ultimate termination of the litigation ...". (Title 28 U.S.C. 1294(b))

Pending resolution of what I anticipate will be immediately filed appeals, this court in no way restrains the liquidation proceedings presently pending or hereafter commenced in the State Court. Should, however, this court be sustained in its jurisdictional ruling those proceedings

will, of course, be most carefully reviewed and analyzed in detail.

In its present posture I express the hope that my ruling on the main issue concerning the scope and meaning of the term "security" will be reviewed and the law of this Circuit determined by our Seventh Circuit Court of Appeals. Should that learned court agree with my resolution of this issue I can then entertain another motion for appointment of a receiver, assuming such relief is still available. [fol. 38] (See *Esbitt v. Dutch-American Mercantile Corp.*, 335 F2d 141) Should it determine I am in error in such resolution then all issues herein, including that seeking appointment of a receiver become moot.

Judge Campbell.

[fol. 39] Clerk's Certificate to foregoing transcript (omitted in printing).

[fol. 40]

IN THE UNITED STATES COURT OF APPEALS

FOR THE SEVENTH CIRCUIT

Nos. 15631, 15633 and 15634

No. 15634

ALEXANDER TCHEREPNIN, et al., Plaintiffs-Appellees,

vs.

ROBERT FRANZ, et al., Defendants-Appellants.

No. 15633

ALEXANDER TCHEREPNIN, et al., Plaintiffs-Appellees,

vs.

CITY SAVINGS ASSOCIATION, DENNIS KIRBY, HARRY HARTMAN
and LOUIS KWASMAN, Defendants-Appellants.

No. 15631

ALEXANDER TCHEREPNIN, et al., Plaintiffs-Appellees,

vs.

JOSEPH E. KNIGHT and JUSTIN HULMAN,
Defendants-Appellants.

Appeal from the United States District Court for the
Northern District of Illinois, Eastern Division.

No. 64-C-1285

Honorable William J. Campbell, Chief Judge, Judge
Presiding.

Plaintiffs-Appellees' Appendix—Filed September 14, 1966

[File endorsement omitted]

[fol. 41] Prepared in abstract and narrative form as a condensation of original documents used in the District Court, of which Plaintiffs-Appellees have filed three copies each pursuant to Rule 18 of this Court. All counsel either had or were served with copies in that Court. (These documents are referred to only at pp. 6, 15, 39, including footnote, and 41 of Plaintiffs-Appellees' Brief. Except for the proxy and letter which are the subject of the reference to the Record at p. 6 of Plaintiffs-Appellees' Brief, the documents abstracted herein have been carefully identified at pp. 15 and 39 of that Brief, for the convenience of this Court and all parties.)

Exhibit 1 filed 6-25-65 in District Court. 370 sheets, names and addresses of investors in City Savings Association. Included are 21 sheets stapled together in Envelope No. 2 of Exhibit 1, showing investors in 43 states, the District of Columbia and foreign countries. (Referred to at p. 39, Plaintiffs-Appellees' Brief.)

Exhibit "C" follows (Record p. 577). Notice of Special Shareholders' Meeting of City Savings Association called for 7/14/64 to vote on proposal to liquidate the Association and appoint liquidation committee. Shareholders unable to be present and who do not have proxy on file with the Assn. requested to sign and return enclosed proxy. (Referred to at p. 6, Plaintiffs-Appellees' Brief.)

Exhibit "D", Form of shareholder's proxy of City Savings Assn. Contains blanks for signature of shareholder and for account number. Appoints officers or a majority of them to vote at any meeting of shareholders. Recites "unless revoked" the proxy is to operate while shareholder continues as such, and "if revoked" revocation applies [fol. 42] only to meeting for or at which "right to revoke" is exercised. (Referred to at p. 6, Plaintiffs-Appellees' Brief.)

Affidavit of George L. Weisbard, C. P. A. Feb. 12, 1966 (Record pp. 545-570). (Referred to at pp. 15, including footnote, and 41 of Plaintiffs-Appellees' Brief.)

Numerous practices and activities of City Savings appear unlawful under Ill. Sav. and Loan Act, including:

1. *Unauthorized investments.*

While the Association was operating under Sec. 4-13 of the Act and limiting withdrawals, about \$9½ million of unlawful investments were made.

2. *Improper extensions of loans.*

Extensions of past due loans were granted, although prohibited by the Act during any period while the Association was operating with unpaid withdrawal demands pending.

3. *Illegal purchases of mortgages.*

4. *Inadequate reserves.*

At no time from 1959 through 1963 were minimum statutory reserves maintained. Thus, unlawful dividends were paid.

5. *Accounting violations.*

Proper accounting principles were not followed, in that unearned discounts and commissions were treated as current income instead of being amortized over a period of years, while advertising expenses which should not have been amortized were improperly deferred and were not deducted from current income.

6. *By-passing the Rotation limitations, requiring pro-rata treatment of withdrawing Shareholders.*

[fol. 43] 7. *Failure to keep proper minutes.*

8. From July 1, 1958 through Dec. 31, 1963 violations of limitations on withdrawal provisions of the Act occurred.

Excess pay-outs through the loan device aggregated almost \$5 million through 1963.

From Jan. 1, 1959 to June 30, 1964 the Association recorded as income about \$3½ million of premiums on loans which sound accounting practice required to be deferred

to the extent that they exceeded the cost of placing the related loans on the books.

It appears that no payments were ever received on these loans and that excessive commissions were charged on the same money by shifting the liability to different loan numbers, resulting in an overstatement of income and assets in each year.

9. *Impairment of capital at December 14, 1963.*

Excessive loans as compared to value of property mortgaged.

Estimated excess of loans over fair value of underlying security at June 30, 1964 \$16½ million so that indicated impairment after crediting reserves and undivided profits was \$15¾ million.

10. At no time from July 24, 1959 to June 30, 1964, when State took custody of the Assn. were sufficient reserves maintained. The overstatement of income was used to pay unearned dividends.

The pre-July 1959 depositors in substantial measure were paid out of the pockets of post-July 23, 1959 depositors.

Necessary effective controls over pay-outs of escrow accounts were lacking. Records were inadequate. Waivers of liens were missing. Improvements in records and controls previously recommended by the auditor of the Assn. had not been made.

[fol. 44] The report prepared by the Assn.'s C. P. A., dated May 11, 1964, analyzed the annual reports of the Association for years 1959 through 1963. It disclosed that unearned income had been recorded.

11. The schedule attached to the Weisbard Affidavit of February 12th indicated that the estimated maximum realizable value of all assets of City Savings Association is about \$10¼ million as against withdrawable capital shares of over \$27½ million.

The Statement of Condition shows no liability for real estate taxes for 1962 or 1963.

SUPPLEMENTARY AFFIDAVIT OF GEORGE L. WEISBARD, C. P. A.
—March 9, 1966. (Record pp. 847-872). (Referred to at pp. 15, including footnote, and 41 of Plaintiffs-Appellees' Brief.)

George L. Weisbard is a C. P. A. and an attorney at law, admitted to the New York, Michigan and Illinois bars for over 20 years. The report of examination of the books of City Savings Association at June 30, 1964 by Theodore E. Weinberg does not purport to be and is nothing more than a reflection of the Association's books. It contains nothing which would change the accounting conclusions reached by Peat, Marwick, Mitchell & Co. or by Mr. Weisbard in his Affidavit of February 12, 1966.

The Weinberg report is not an audit. The Statement of Operations therein includes as 1964 income all commissions charged on loans made during the six-month period covered by that statement. Generally accepted accounting principles and regulations of the Illinois Department of Financial Institutions require that commissions on loans, in excess of cost of putting the loans on the books, be amortized over the life of the loan. In the six-month period the amortization should have been \$50,000, so that income [fol. 45] was overstated by about \$460,000 by reason of those commissions alone.

The Weinberg report refers to a letter to shareholders of City Savings. (Exhibit "C", referred to in this appendix.)

It was misleading because:

a. The term "voluntary liquidation" was used loosely.

b. It implied that the shareholders would receive 100 cents on the dollar in liquidation which was untrue.

c. It implied that the Association was able to pay a dividend, although there was no cash to pay any dividend.

d. Statement that \$89,000 remained in undivided profits after the dividend was untrue.

e. The reason stated for going out of business was false. In truth, the bulk of loans were being refinanced

instead of collected and the payments from the remaining loans were insufficient to meet payroll and operating expenses.

f. Since the Association was not meeting withdrawal requests through profits and was receiving no cash payment on almost \$27 million of its \$32 million in loans the cash withdrawn in excess of receipts from the remaining \$5 million of loans, about \$10¼ million since July 24, 1959, must have come from new depositors (see Schedule II appearing at R. 859).

g. The voluntary plan would be supervised by the depositors themselves, which was untrue.

h. The Peat, Marwick, Mitchell & Co. report was not disclosed.

The Weinberg report also included a notice of a special meeting of shareholders to be held 7/28/64. It did not refute the misleading statements in the prior letter per [fol. 46] taining to the meeting originally set for 7/14/64. It contained at least 8 misrepresentations cited by Mr. Weisbard including that the liquidation was voluntary, without disclosure that it was forced by the Department of Financial Institutions.

A purported letter, of June 25, 1964, discloses that Defendants Knight and Hulman believed then that "the individual shareholders of the Assn. will suffer a substantial loss if the Assn. is closed." Peat, Marwick, Mitchell & Co. undertook to verify the value of the assets of City Savings in preparing their report.

Property referred to in the Weinberg report included 48 improved properties carried at cost "which was frequently in excess of fair market value." These represented ⅔rds of the properties owned by the Assn. The fixed asset account failed to recognize that \$367,800 had been overpaid for remodelling City Saving's headquarters, as found by the U. S. Tax Court, 37 T. C. 703.

Almost \$6 million to be disbursed represents commitments in excess of cash available and in so-called escrow

accounts. The Peat, Marwick report and the Mize audit indicate that escrow accounts were not actually maintained, so the Weinberg report as to amounts in escrow accounts is inaccurate in that the funds were either nonexistent or had been misappropriated.

Weinberg report omitted liability for 1963 and 1964 real estate taxes from the statement of condition. The reserve for uncollected interest was understated because of unlawful refinancing of delinquent loans, thereby adding uncollected interest to the original loan and inflating receivables and income.

Sec. 4-13 of the Ill. Sav. & Loan Act had been violated in making share loans, which were extinguished by being offset against shareholder accounts in violation of the [fol. 47] priority rotation system required by the Ill. Act. Advertising issued by the Assn. stated that it was "Under State Government Supervision" as illustrated by Exhibits "B", "C", and "D", being circulars issued in 1962, 1963 and 1964.

PEAT, MARWICK, MITCHELL & Co.'s SPECIAL REPORT in re City Savings Association, as at April 30, 1964, to the Illinois Director of Financial Institutions on June 15, 1964.

(This report was transmitted to the Court of Appeals on August 19, 1966 under the certification of the Clerk of the United States District Court of the Northern District of Illinois. At request of Defendant Liquidators, this document was impounded by Judge Igoe on June 25, 1965. Impounding order was lifted on February 21, 1966 by order of Judge Campbell. Because no record page numbers appear thereon, the page numbers herein below set forth refer to the paging of the document. The matters contained in this Report are referred to at p. 15 of Plaintiffs-Appellees' Brief.)

Letter report, June 15, 1964, addressed Director, Department of Financial Institutions. Reports to Director as of April 30, 1964 on the analysis of books of account and accounting procedures of City Savings.

Mr. Mize, the CPA of City Savings, did not render an opinion as to the condition of the Assn. as of 12/31/63. Based on the Peat, Marwick analysis of the Assn.'s records, the Director of the Department of Financial Institutions had reason to take custody of the Assn. under Sec. 7-8 of the Illinois Savings and Loan Act for the following reasons:

- (1) Withdrawable capital impaired; insufficient to pay in full creditors and holders of withdrawable capital;
- [fol. 48] (2) The business of the Assn. was being conducted in an unsafe manner;
 - a. Dividends for 1963 were about \$125,000 in excess of net income and accumulated undivided profits, and the earnings during four months of 1964 were \$50,000 less than estimated dividend requirements;
 - b. During 1963 the contingent reserve was reduced by about \$127,000 instead of being increased by \$87,000 as required by the Illinois Act.
 - d. The test appraisals of real estate made by the qualified independent appraiser for the purpose of the Peat, Marwick report indicate that the security is not good and ample for the loans, as required by the Illinois Act.

The Assn. has not followed generally accepted accounting principles in its treatment of advertising expenses and premiums on loans. Internal controls for the year 1963 were inadequate in various specific ways detailed at page 3 of the Peat, Marwick Report.

As of April 30, 1964 a reasonable estimate of the impairment of capital is over \$14 $\frac{1}{3}$ million arising because of excessive book values of loans over current appraisal values, and because of five other listed causes.

82% of the total portfolio of mortgage loans went into two development projects, Apple Orchard at Bartlett, Illinois, and Howie in the Hills, Hoffman Estates, Illinois. This represents a large concentration of risk.

Since January 14, 1959, when Apple Orchard was started, and October 5, 1960, when Howie in the Hills was started, the Assn. has financed and refinanced the same properties to the extent of \$64¼ million.

In the categories of both real estate owned and real estate in judgment subject to redemption the cost was [fol. 49] in excess of current realizable value, involving an aggregate of 145 parcels. The promotional items on hand did not amount to any appreciable inventory and there was no valid reason for a financial institution to defer \$373,392 of advertising expenses. This amount constitutes an impairment of assets.

Escrow agreements and other supporting evidence for the payout of funds from escrow accounts were missing in many cases. Management had a policy of disposing of all supporting data up to the date of the last State examination. Upon inquiry for data supporting pay-outs subsequent to the last State examination no adequate documents were produced.

Loans in Process Records followed a pattern similar to the escrow accounts.

Appendix B to the Peat, Marwick Special Report contains a list of pay-outs for which there were no supporting documents totaling almost \$2,000,000.

The premiums on loans treated as income in each year 1958 to 1964 were in excess of related costs and should not have been treated as income in the years so treated.

As to American Fidelity Insurance Co. Ltd., to which references were made in the Peat, Marwick Report at Appendix A, the Illinois Department of Insurance reports that it has no record of this company being licensed to operate in Illinois.

[fol. 50] Clerk's Certificate to foregoing transcript (omitted in printing).

[fol. 51]

IN THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

September Term, 1966—January Session, 1967

No. 15631

ALEXANDER TCHEREPNIN, et al., Plaintiffs-Appellees,

v.

JOSEPH E. KNIGHT and JUSTIN HULMAN,
Defendants-Appellants.

No. 15633

ALEXANDER TCHEREPNIN, et al., Plaintiffs-Appellees,

v.

CITY SAVINGS ASSOCIATION, DENNIS KIRBY, HARRY HARTMAN
and LOUIS KWASMAN, Defendants-Appellants.

No. 15634

ALEXANDER TCHEREPNIN, et al., Plaintiffs-Appellees,

v.

ROBERT FRANZ, et al., Defendants-Appellants.

Appeal from the United States District Court for the
Northern District of Illinois, Eastern Division.

OPINION—January 20, 1967

Before Knoch, Kiley and Cummings, Circuit Judges.

Knoch, Circuit Judge. The City Savings Association, an Illinois savings and loan association, is now in process [fol. 52] of voluntary liquidation. When this Complaint

was filed in the United States District Court, the Association was in the custody of the defendant, Joseph E. Knight, Director of Financial Institutions of the State of Illinois. He had assumed custody on June 26, 1964, under authority of the Illinois Savings and Loan Act, Illinois Revised Statutes, Chapter 32 §848. The defendant Justin Hulman is the Supervisor of the Savings and Loan Division of the Department of Financial Institutions.

At a special meeting on July 28, 1964, the shareholders of City Savings approved a plan of voluntary liquidation and elected the defendants Louis Kwasman, Harry Hartman and Dennis Kirby liquidators to carry out the plan which was approved by the Department of Financial Institutions as evidenced by a certificate filed with the Cook County Recorder of Deeds on August 7, 1964, at which time the plan became effective.

Meanwhile, on July 24, 1964, this action was filed by the plaintiffs-appellees, Alexander Tcherepnin, Ming Tcherepnin, et al., who describe themselves as purchasers, at various dates, of securities issued by City Savings, consisting of capital shares of and a capital interest in City Savings.

Under the Illinois Savings and Loan Act, Illinois Revised Statutes, Chapter 32, §§701-944, an association unable to meet its cash commitments could limit the amount of cash a depositor might withdraw, [§773(b)] as City Savings did in 1958. It was then prohibited from accepting new deposits. The Act was amended on July 9, 1959 [§773(h)] to allow acceptance of new deposits on which it was prohibited to place limitations of withdrawal.

The accounts represented by the plaintiffs according to the Complaint were all opened under the 1959 amendments and hence are fully withdrawable despite the conclusory assertions in the Complaint that plaintiffs purchased their shares on a restricted withdrawal basis.

The plaintiffs brought this action for themselves and all other persons who made deposits in City Savings since

July 23, 1959, to have their purchases of shares declared void and to be declared creditors of City Savings.

[fol. 53] They invoked jurisdiction of the District Court under §27 of the Securities Exchange Act of 1934 (Title 15, U.S.C. §78aa). Diversity of citizenship is lacking here. In addition to those noted above, the Complaint lists as defendants: the City Savings Association, and certain of its former officers and directors.

The Securities and Exchange Commission was allowed to intervene as *amicus curiae*. A group purporting to represent other depositors was allowed to enter the case as party-defendants.

The Complaint alleged that in making their deposits the plaintiffs relied on false and misleading solicitations mailed to them in violation of §10(b) of the Securities Exchange Act of 1934, and of the General Rules and Regulations promulgated thereunder, which rendered their purchases void under §29(b) of the Act entitling them to rescind their investments and to recover the amount of their investments plus interest.

The defendants City Savings and the three liquidators moved to dismiss the Complaint for lack of jurisdiction in the District Court because the subjects of the action—withdrawable capital accounts of a state-chartered savings and loan association—were not “securities” within the meaning of the Act. The other defendants also moved to dismiss the action. All the motions were denied.

The question presented by denial of motion to dismiss was certified by the District Court under §1292(b) of the Judicial Code (Title 18 U.S.C. §1292(b)). This Court granted petition for leave to file interlocutory appeal.

We are thus presented with one contested issue: is a withdrawable capital account in an Illinois-chartered savings and loan association a “security” within the meaning of that term as it is used in the Securities Exchange Act of 1934?

The plaintiffs-appellees and the Securities and Exchange Commission, which has filed its brief in these cases as

amicus curiae, both assure us that a withdrawable capital account in an Illinois-chartered savings and loan association is such a "security"; that Congress intended to [fol. 54] include such accounts within the broad definition of the Act, particularly as shown by subsequent amendments. They also point to court decisions classifying as "securities" some interests which possess some similar characteristics, which they view as the fundamental characteristics of these accounts. On the other hand, they see the other rather strikingly distinctive characteristics of these accounts, on which the appellants rely, as not fundamental but as merely subsidiary, some of even these being also present in other interests which have been accepted as securities.

The Act provides the following definition of a "security":

"The term 'security' means any note, stock, treasury stock, bond debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a security; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding 9 months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited." Securities Exchange Act of 1934, §3(a)(10), 15 U.S.C. §78c(a)(10)

The type of interest now before us, if it is covered by this definition, must be "an instrument commonly known as a security."

The report accompanying the predecessor Act, cited as the Securities Act of 1933, noted that the term "security" was so defined as to include the many types of instruments which in the commercial world fell within the "ordinary concept of a security." H.R. Rep. No. 85, 73rd Cong., 1st Sess. 5/4/33 p. 11.

[fol. 55] As appellants state, these accounts are unlike the ordinary concept of a security in such characteristics as being permissibly issued in unlimited amounts; as not made subject to the securities article of the Uniform Commercial Code; as not negotiable and transferable only by assignment; as subject to forced redemption and retirement on call of the board of directors; as fully matured and withdrawable when issued; as without preemptive rights; as evidenced by an account book, the holders of which are not entitled to inspect the general books and records of the association; although entitled to vote for directors, to give a proxy which may (and usually does) provide that it is irrevocable, and which is typically executed when the account is opened, and to receive dividends.

The Illinois statutes which created withdrawable accounts in savings and loan associations show clearly that the Illinois legislature did not intend them to be securities. It thus seems difficult to assert that these interests can be "commonly known as a security."

According to its preamble, the Securities Exchange Act is designed to regulate transactions in securities as commonly conducted on securities exchanges and over-the-counter markets, the price of such securities being susceptible to manipulation and control and the dissemination of such prices giving rise to excessive speculation resulting in sudden and unreasonable fluctuations in the prices of securities.

The 1934 Act expressly excludes debtor-creditor relationships represented by notes maturing in nine months of issuance. The interest with which we are concerned is mature at issue.

The Federal Bankruptcy Act, Title 11 U.S.C. §22, exempts State building and loan associations from federal bankruptcy adjudication. See *Security Building & Loan Assn. v. Spurlock*, 9 Cir., 1933, 65 F. 2d 768, 771, where the Court quotes extensively with approval from Rep. 98, 72d Congress, 1st sess. House Judiciary Committee; House Reports 2-659, 72d Cong. 1st sess., indicating Congressional determination to leave the administration of State created building and loan associations in the local [Col. 56] courts. We may assume that City Savings would be exempt from the provisions of the Bankruptcy Act. *Home Savings and Loan Assn. v. Plass*, 9 Cir., 1932, 57 F. 2d 117.

In *S.E.C. v. Joiner Corp.*, 320 U.S. 344, 352-3 (1943), the Court was considering whether assignments of oil leases were securities under the Act. In that connection the Court said:

The test rather is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect.

At another point (p. 351) the Court said:

[T]he term "security" was defined to include . . . documents in which there is common trading for speculation or investment.

In *S.E.C. v. Howey Co.*, 328 U.S. 293 (1946) the Court said:

The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.

An "investor" in a savings and loan association lends his money to be withdrawable at will and to earn interest. The relationship with the enterprise is much more that of debtor-creditor than investment. The profit is derived

from loans to other members of the savings and loan association. This is not investment in a common enterprise with profits to come solely from the efforts of others.

The Securities Act of 1933 and the Securities Exchange Act of 1934 were passed in the aftermath of the great economic disaster of 1929. Congress was concerned with speculation in securities which had a fluctuating value and which were traded in securities exchanges or in over-the-counter markets.

The S.E.C. relies heavily on a recent amendment. Section 12(g), Title 15 U.S.C. §78 1* (g), provides for registration [fol. 57] of certain equity securities. There is a specific exemption of "any security [with certain exceptions not pertinent here] issued by a savings and loan association" §12(g)(2)(C). The S.E.C. thus argues that the definition of "security", *supra*, must include interests which are referred to as securities in this exemption.

If these interests were already excluded by the definition, the Commission argues, then the exemption would be meaningless or would have to be interpreted as referring to some other undefined security of a savings and loan association.

In its Technical Statement on H.R. 6789, H.R. 6793, and S. 1642, submitted at the Hearings before a Subcommittee of the Committee on Interstate and Foreign Commerce; House of Representatives, 88th Congress, 1st Session (1963), p. 215, the S.E.C., while referring to all other interests which it recommended for exemption as being "securities", speaks of "share accounts" when referring to the savings and loan associations, suggesting that a distinctive view was held of these interests by the Commission itself.

The S.E.C. sees no significance in the omitting from the definition in the 1934 Act of the term "evidence of indebtedness" which does appear in the definition in the 1933 Act. These Acts were considered to have been sub-

* Lower case letter L.

stantially the same. The S.E.C. sees the omission as merely indicative of a different draftsman.

The Commission also notes that there was apparently no discussion of savings and loan interests at the time the 1934 Act was passed.

However, appellants invite our attention to the lengthy consideration of the term "evidence of indebtedness" in connection with the 1933 Act. (Hearings on S. 875 before Senate Committee on Banking and Currency, 73rd Cong. 1st sess., pp. 94-120 passim.)

Some of the Senators evidently saw a relationship between this term "evidence of indebtedness" and accounts in building and loan associations as well as between the term and various short term banking transactions. There was some fear that the 1933 Act would interfere with ordinary commercial banking transactions. The term was retained but certain short-term debtor-creditor transactions were exempted. The same Congress which in 1933 had been considering the relationship between the term "evidence of indebtedness" and accounts in building and loan associations, excluded that term from the 1934 Act, retaining only such evidences of indebtedness as long-term notes, bonds and debentures. Yet the Investment Act of 1940, Title 15 U.S.C. §80a-2 (35), for example, retains the term in its definition of "security". Congress must have had some intention of excluding those interests which fell under the broad character of "evidence of indebtedness."

The definitions set out in the Act are all preceded by an introductory statement that they apply "unless the context otherwise requires."

Perhaps insurance policies may provide a useful analogy. In discussing mutual insurance companies over whom the S.E.C. does not claim jurisdiction, Chairman William L. Cary, of the S.E.C. said:

[W]e do say that mutual insurance companies are not included under this bill because the buyers in mutual insurance companies are fundamentally buying insur-

ance. * * * and not stock. Furthermore, because there is no stock, there is no trading in the stock. (House Hearings, 1963, supra, p. 309.)

Basically that distinction applies to holders of "share accounts" in savings and loan associations. There is no stock or trading in stock.

A little later, Chairman Cary said:

[S]ince the holders in mutual companies are policy holders, any wrongdoing would be the responsibility of the State superintendent of insurance.

With respect to City Savings, also, the local State authorities are ready and able to handle the orderly disposition of the institution's liquidation.

Insurance policies were exempted from the Securities Act of 1933 [Title 15 U.S.C. §77e(a)(8)] and under the 1964 amendments [Title 15 U.S.C. §78 1* (g)(2)(G)]. [fol. 59]. Are they necessarily included in the definition of "securities"?

Professor Loss (*Securities Regulation*, 2d ed. 1961, p. 497) says that on its face the exemption of insurance policies in the 1933 Act seems to create a negative implication that insurance policies are securities which may be exempt from registration but are subject to the anti-fraud provisions. He observes that the Commission takes the position with respect to insurance policies that they are not intended to be "securities".

Chairman Cary advised, in the course of the Hearings before the Subcommittee in 1963, supra, p. 300, that while his Commission regulated offering of variable annuities as an offering of securities subject to the 1933 Act, he wanted to emphasize the fact that it was only the investment company operation that was regulated; that "we don't touch the insurance operations that they may have."

* Lower case letter L.

Professor Loss also notes that the House Report states that the purpose of the exemption is to make clear what was implied in the Act, that insurance policies are not to be regarded as securities subject to the provisions of the Act. See H.R. Rept. 85, 73rd Cong., 1st sess. (1933) 15, cited in *S.E.C. v. Variable Annuity Co.*, 359 U.S. 65, 74, n. 4 (1959) in Justice Brennan's concurring opinion, where he states that under the Securities Act of 1933, it would appear that for ordinary insurance policies the exemption is just confirmatory of the policy's non-coverage under the definition of security.

H.R. Rept. 85 states that:

The entire tenor of the act would lead, even without this specific exemption, to the exclusion of insurance policies from the provisions of the act, but the specific exemption is included to make misinterpretation impossible.

It seems likely that the specific exemption of the interest here under consideration was also inserted for the same reason. This seems a more reasonable interpretation than that urged on us by the appellees and the Commission. [fol. 60] The appellees and the Commission cite a number of cases from which we are invited to draw analogies favorable to their view. However, these deal largely with the 1933 Act which included the broad term "evidence of indebtedness" which, as indicated, was excluded from the 1934 Act with which we are here concerned, or which are otherwise not directly helpful. Neither the parties nor this Court has found a case directly in point.

We have carefully considered all other arguments advanced and have studied all authorities cited. It is our opinion that these interests are not encompassed in the definition of a "security" under the 1934 Act; that the anti-fraud provisions of that Act are not here applicable; and that the District Court lacked jurisdiction of this cause.

The decision of the District Court is therefore reversed and the cause is remanded with instructions to dismiss the Complaint.

Reversed and Remanded With Instructions.

CUMMINGS, *Circuit Judge* (dissenting). My conclusion is that Chief Judge Campbell of the District Court correctly held that withdrawable capital shares¹ in Illinois savings and loan associations are "securities" within the meaning of Section 3(a)(10) of the Securities Exchange Act of 1934 (15 USC § 78c(a)(10)), so that the anti-fraud provisions of that statute are applicable to this case. Savings and loan passbooks typically describe the owners as holding a savings account representing "*share interests*" in the association. Many associations reserve the right to require 30 days' notice for withdrawals. Insurance, when available through the Federal Savings and Loan Insurance Corporation, gives \$15,000 maximum coverage up to the [fol. 61] "full withdrawal or repurchasable value of the accounts of each of its * * * investors * * * holding withdrawable or repurchasable *shares*" (12 USC § 1728(a)). (Italics supplied.)

Section 3(a)(10) is quoted in the majority opinion and defines "security" as including, *inter alia*, any "stock * * * certificate of interest or participation in any profit-sharing agreement * * * transferable share, [or] investment contract". This definition is substantially the same as that contained in Section 2(1) of the Securities Act of 1933 (15 USC § 77b (1)), so that the legislative history and

¹ *Arguendo*, the majority and this dissenting opinion consider these as withdrawable shares in accordance with the then applicable provisions of the Illinois Savings and Loan Act (Ill. Rev. Stat., 1963; c. 32 § 773(h)). However, the complaint alleges that since 1959 the shares were sold on a restricted withdrawal basis. At trial, the District Court would have to determine whether defendants could sell shares restricted against withdrawal. That point has not been considered in this Court.

judicial construction of the definition in the Securities Act lend meaning to the definition in the complementary 1934 Act.

In enacting the Securities Act of 1933, Congress exempted "any security issued by a * * * savings and loan association" from the registration provisions while subjecting them to the fraud provisions of that statute (15 USC §§77c(a)(5) and 77q(a) and (c)). (Italics supplied.) While the savings and loan industry representatives were desirous of an exemption from the registration provisions of the 1933 Act, their spokesman, the late Morton Bodfish, supported the application of the anti-fraud provisions of the statute to the issuance of savings and loan shares, which he described *passim* as securities.² This specific exemption shows that when Congress wished to exclude savings and loan accounts, it knew how to do so. It has never chosen to exclude them from the anti-fraud requirements of the 1934 Act. The majority opinion relies on the securities exemption of ordinary insurance policies under the 1933 Act, but they differ from withdrawable capital accounts because they possess none of the attributes of securities. As Professor Loss observes, the exemption of insurance policies was supererogation due to an excess of caution. 1 Loss, *Securities Regulation* (2d ed 1961) pp. 496-497. Therefore their exemption does not show they are subject to the anti-fraud requirements of the 1933 Act, particularly since the 1933 legislative history shows that they were "not to be regarded as securities" (*idem*).

[fol. 62] When Congress enacted the Securities Exchange Act of 1934, there was no discussion of savings and loan interests during the consideration of the definition of a

² Hearings on H.R. 4314 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 1st Sess., pp. 72-74. See also Hearings on S. 875 before the Senate Committee on Banking and Currency, 73d Cong. 1st Sess. pp. 50-54 (1933); Richards, *The Federal Securities Act*, Building and Loan Annals (1933), pp. 111, 115-118.

security in that Act.³ However, in 1964, in amending the 1934 Act by providing for the registration of equity securities by certain issuers, Congress exempted "any security * * * issued by a savings and loan association" from the new registration provisions (15 USC § 781(g)(2)(C). (*Italics supplied*) The then Chairman of the Securities and Exchange Commission, William L. Cary, explained the exemption as follows:

"Because of the fact that most savings and loan associations issue so-called shares, which in fact merely evidence the existence of a savings account, special provision had to be made to exempt that type of 'share'".⁴

No exemption would have been necessary unless shares in savings and loan associations were already within the definition of a security under Section 3(a)(10) of the Securities Exchange Act. This exemption was justified in the Senate Report on the ground that "There is normally no trading interest in the remaining *categories of securities* [including share accounts in savings and loan associations] exempted from the registration provisions." S. Rep. No. 379, 88 Cong., 1st Sess., p. 61 (1963). (*Italics supplied*) Thus the Senate Committee on Banking and Currency understood such share accounts to be "securities."

The definition of a "security" in the Securities Act of 1933 was involved in *Security and Exchange Commission v. W. J. Howey Co.*, 328 U.S. 293. The Court said that the term security "embodies a flexible rather than a static

³ There has been no showing that the deletion of "evidence of indebtedness" (found in the "security" definition in the 1933 Act) from the 1934 Act's definition of a security was intended to exempt savings and loan accounts. The author of the 1934 Act may have decided that inclusion of "evidence of indebtedness" would be poor draftsmanship, that term being inconsistent with the exclusion of "any note, draft, bill of exchange, or banker's acceptance" (15 USC § 78c(a)(10)).

⁴ Hearings on H.R. 6789, H.R. 6793 and S. 1642 before a Subcommittee of the House Committee on Interstate and Foreign Commerce, 88th Cong., 1st Sess. p. 1213 (1963).

principle" in order to meet the "variable schemes devised [fol. 63] by those who seek the use of the money of others on the promise of profits" (at p. 299). Therefore, it held that a sale of a parcel of land in citrus groves, when coupled with a contract for management services, was an "investment contract" within the definition of a security under the 1933 Act. In language applicable here, the Court stated (at pp. 298, 299):

"an investment contract for purposes of the Securities Act means a contract, transaction or scheme where a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise."⁵

Here too the shareholders in this Illinois savings and loan association invested their money in a common enterprise and were led to expect profits from the efforts of others, *viz.*, the management. As in *Howey*, it is immaterial whether their shares were evidenced by formal certificates. Whether or not plaintiffs' shares are an "investment contract" under the *Howey* case, the Securities Exchange Act applies if they are "stock", a "transferable share" or a "certificate of interest or participation in a profit-sharing agreement." The subsequent clause in Section 3(a)(10) referring to "in general, any investment commonly known as a 'security'" is not a limitation upon the preceding categories. *Llanos v. United States*, 206 F.2d 852, 854 (9th Cir. 1953) certiorari denied, 346 U.S. 923. It must be remembered that these various categories in Section 3(a)(10) are not mutually exclusive and are meant to be "catchalls". 1 Loss, *Securities Regulation*, (2d ed 1961) pp. 483, 488-

⁵ The broad *Howey* formula has been codified into a rule under the Illinois "blue sky" statute. 1 Loss, *Securities Regulation* (2d ed 1961), pp. 487-488, note 79. Ill. Rev. Stat., 1965, C. 121½, § 137.1-1.

489. The breadth of the definition of security in the two Acts is shown by Professor Loss' illustrations of coverage in cases involving animals, fishing boats, automobile trailers, vending machines and parking meters, cemetery lots, tung trees, vineyards, fig orchards, farm lands, and patent [fol. 64] rights. 1 Loss, *Securities Regulation* (2d ed 1961) pp. 490-491 and 1962 Supplement, p. 30. All sorts of schemes, "many of them of the Alice in Wonderland variety", are regulated through "the *Joiner-Howey* process of looking through form to substance" and through the broad definition of "security" found in the two Acts. *Idem*, pp. 488-489. Under the definition of a security under the 1933 and 1934 Acts, a writing is not essential. 1 Loss, *Securities Regulation* (2d ed 1961) pp. 458, 488-489. Moreover, these passbooks would qualify as writings and indeed as certificates "of interest or participation in any profit-sharing agreement" (15 USC §78e(a)(10)).

As observed in a similar context, it is unnecessary to pigeonhole these withdrawable capital shares into one category of security or the other. Cf. *Securities and Exchange Commission v. Variable Annuity Co.*, 359 U.S. 65, 80 (concurring opinion). In addition to the *Variable Annuity* and *Howey* cases, *Securities and Exchange Commission v. Joiner Corporation*, 320 U.S. 344, indicates that these companion statutes must be liberally construed in view of their remedial purpose. There the "investment contract" part of the security definition in the 1933 Act was deemed applicable to non-standard offerings of variable character (at p. 351). Our Court has also favored a broad construction in *Securities and Exchange Commission v. Crude Oil Corp.*, 93 F.2d 844, 846 (7th Cir. 1937); and *Securities and Exchange Commission v. Universal Service Corporation*, 106 F.2d 232, 237 (7th Cir. 1939), certiorari denied, 308 U.S. 824.

Although the foregoing cases involved the Securities Act of 1933, the definition of a security in the Securities Exchange Act was involved in *Securities and Exchange Commission v. Los Angeles Trust Deed & Mortgage Exchange*,

186 F. Supp. 830, 886-888 (S.D. Cal. 1960), affirmed in pertinent part, 285 F.2d 162 (9th Cir. 1960), certiorari denied, 366 U.S. 919. In affirming the District Court's holding that defendant's sales of second trust deeds constituted sales of "securities" within the 1933 and 1934 statutes, the Ninth Circuit noted that "Howey adds the test of *common enterprise* to the Joiner test of *results dependent on the efforts of one other than the purchaser*" (285 F.2d at p. 168; court's [fol. 65] italics). There the defendant selected a trust deed for the investor and serviced it by making the collections from the grantor-debtor and by doing the bookkeeping. Basically the system was very much like a savings and loan association, for funds supplied by investors were used to finance secured loans on real property. In *Los Angeles Trust Deed*, the investors' money was used to buy a particular deed, whereas savings and loan associations make their loans from commingled savings. This difference satisfies the "common enterprise" *Howey* test even more than the trust deed system in *Los Angeles Trust Deed*. Under that case, the instant plaintiffs' shares clearly represent an "investment contract" within the security definition in the 1934 Act.

In *Securities & Exchange Commission v. American International Savings and Loan Ass'n.*, 199 F.Supp. 341, 346 (D.Md. 1961), the association's articles provided for preferred stock to be known as preferred share or savings share accounts. Deposit books were issued to depositors, who were entitled to receive cumulative dividends of at least 3½% before any dividends were paid to common stockholders. Since the court held that defendants violated the 1933 Act, it necessarily concluded that this preferred stock, which resembled withdrawable capital shares in the City Savings Association, was a security within the purview of the 1933 Act.⁶ Applying *American International* here would

⁶ In *United States v. Hopps*, 215 F.Supp. 734, 754 (D.Md. 1962), affirmed 331 F.2d 332 (4th Cir. 1964), certiorari denied, 379 U.S. 820, the same judge described interests in savings and loan associations as "securities".

mean that these shares qualify as securities under the like definition in the 1934 Act.

A recent Illinois decision involving a savings and loan association also shows that these withdrawable shares are "securities". Thus in *Marshall Savings and Loan Association v. Henson*, Ill. App.2d , N.E.2d (No. 51485, 1966), the Appellate Court of Illinois observed "that the Illinois Savings and Loan Act gives the depositors the status of *shareholders* by conferring one vote for each \$100 on deposit" (italics supplied). There it was held that the Federal Savings and Loan Insurance Corporation, as as-[fol. 66] signee of Marshall's withdrawable share accounts, had obtained the right to vote the "stock" or "shares" even though Marshall's members had not endorsed their certificates or passbooks to the Federal Savings and Loan Insurance Corporation. Similarly, *Wisconsin Bankers Association v. Robertson*, 294 F.2d 714 (D.C. Cir. 1961), certiorari denied, 368 U.S. 938, concluded that the holder of a savings account in a savings and loan association was a shareholder and not a creditor of the association, and that such associations were not banks. The concurring opinion of Judge Burger noted that the owner of a savings and loan association account is an investor and is entitled to vote for management. See also *Aetna Casualty & Surety Company v. Porter*, 296 F.2d 389 (D.C. Cir. 1961), reversed on other grounds, 370 U.S. 159. As further evidence of the distinction between savings and loan associations and banks, we have been advised that as of December 31, 1965, the mortgage loans of savings and loan associations were 85.14% of their total assets, whereas the comparable percentage for commercial banks was only 13.11%. Banks are in a much more liquid position than those associations, demonstrating that investors in such associations need the disclosures required under the 1934 Act.

The majority opinion and the defendants reason that these withdrawable capital accounts form a "debtor-creditor relationship" and are not investments. This reasoning is contrary to Section 4-13(f) of the Illinois Savings and

Loan Act (Ill. Rev. Stat., 1965, c. 32 § 773(f), which provides:

"The holder of withdrawable capital for which an application for withdrawal has been made, does not become a creditor by reason of such application."

Both the *Wisconsin Bankers* and *Aetna Casualty* cases also hold that a creditor-debtor relationship is not present here. If these shareholders were creditors, they would be entitled to interest. Actually they are entitled to receive only dividends payable out of the association's profits, if any.

To avoid the security definition, appellants emphasize the withdrawability and non-preemptive rights attached to these savings and loan shares, but the same is true [fol. 67] of mutual fund shares. They are of course "securities" subject to the anti-fraud provisions of the 1933 and 1934 Acts. Also in truth these savings and loan shares are less "withdrawable" than stocks which can be sold immediately merely by phoning a broker. As to savings (and loan shares, the investor may have to wait 30 days or more for withdrawals, and the association may limit the amount of withdrawals (Ill. Rev. Stats. (1965) c. 32 § 773(a) and (b)). If as here, the association has suffered reverses, withdrawability is an empty right. Also, these shareholders' right of redemption and their right to vote for directors, to participate in dividends, and to obtain a certificate of ownership are all common characteristics of securities. It is immaterial that they had no right to inspect City Savings' books and records. Neither do bondholders or holders of such interests as involved in *Howey*, and yet the 1934 Act applies to those categories.

Defendants and the majority opinion assert that these savings and loan interests are not securities because the Illinois Savings and Loan Act provides that they are not subject to Article 8 of the Uniform Commercial Code (Ill. Rev. Stat., 1965, c. 32 § 768(c)). However, if the Illinois Legislature did not consider these accounts to be securities, there would have been no need to exclude them

from the Uniform Commercial Code. The comment on Article 8 of the Uniform Commercial Code recognizes that the definition of security contained in Article 8 is less broad than the Securities Act of 1933, the Securities Exchange Act of 1934, and the Illinois Securities Law of 1953. (See Uniform Commercial Code, Illinois comment, Smith-Hurd Ill. Stats. Ann., c. 26 § 8-102.) It is significant that the Illinois Securities Act of 1953 recognizes withdrawable capital share accounts as securities. Thus that Act affords an exemption to "the following securities: * * * Securities issued by * * * any savings and loan association * * *" (Ill. Rev. Stats., 1965, c. 121½, § 137.3D).

The majority opinion and the defendants also rely on the short-term commercial paper exclusion in the definition of "security" in Section 3(a)(10) of the Securities Exchange Act for "currency, or any note, draft, bill of [fol. 68] exchange, or banker's acceptance" having a maturity not exceeding nine months at issuance. Plaintiffs' interests in City Savings are neither currency nor short-term commercial paper of non-investment character and therefore do not fall within this exclusion. Finally, in this connection, Section 4-13(f) of the Illinois Savings and Loan Act (Ill. Rev. Stat., 1965, c. 32 § 773(f)), providing that a holder of withdrawable capital does not become a creditor even upon filing an application for withdrawal, rebuts any argument that plaintiffs' interests were short-term debts within the commercial paper exclusion.

Defendants and the majority opinion point to the savings and loan association exemption in the Federal Bankruptcy Act (11 USC § 22) in an effort to show that Congress intended to exempt such associations from all federal regulation. But railroads, for example, are also exempted from the Bankruptcy Act, and of course their securities are subject to the Securities Act and the Securities Exchange Act. The exemption of an association from one federal Act certainly does not show that it is to be exempted from the scope of other federal Acts.

The opponents of federal regulation emphasize the non-marketable of these shares, but the scope of the 1934 Act is of course not limited to securities traded on markets. *Schine v. Schine*, 250 F.Supp. 822, 823 (S.D.N.Y. 1966) and cases cited. These shares were transferable, and at the oral argument it was undenied that such shares have been traded over-the-counter. The preamble of the Securities Exchange Act covers the regulation of over-the-counter markets (H.R. 9323, Public No. 291, 73d Cong., 1st Sess. (1934)), and Section 10(b) of the Act reaches manipulative or deceptive devices or contrivances employed in connection with the purchase or sale of any security not registered on a national exchange (15 USC § 78j(b)). Because shares in savings and loan associations are sold on over-the-counter markets, the SEC has required the registration of brokers who deal solely in such shares. In any case, the oil leases, orange groves and variable annuity policies involved in the Supreme Court's *Joiner*, *Howey* and *Variable Annuity* cases were not traded on exchanges or over the counter, and yet all were held to be securities even though they had none of the ordinary characteristics of securities described in the present majority opinion. Also, none of those cases relied on "evidence of indebtedness" as found in the 1933 Act's security definition. Hence the absence of that term from the otherwise similar definition in the 1934 Act does not show that the other terms in the 1934 definition must be given a narrower construction. In that trio of leading cases, it was much more difficult to justify applicability of the federal statute than here, for there was seemingly a strong Congressional policy against federal regulation, less need for investor protection and less statutory support. Here, as seen, the savings and loan industry welcomed the federal anti-fraud umbrella, the investors need federal protection, and the 1934 statutory definitions of a security are clearly broad enough to cover these shares.

² Section 4-8(b) of the Illinois Savings and Loan Act (Ill. Rev. Stat. (1965), c. 32 § 768(b)).

Policy considerations also require affirmance of the decision below. The typical savings and loan account-holder is a small investor, as unwary and in need of protection as a typical, unsophisticated holder of corporate stock. Protection is especially warranted here, for compliance with rules and regulations under Section 10(b) of the 1934 Act (15 USC § 78j(b)) would not involve any excessive burden on these associations, nor is there any undue intrusion on State regulation. In fact, the briefs of the Illinois Attorney General point to no comparable Illinois statutory protection and do not show as a matter of federal-state relations why the 1934 Act should not be applied.

Defendants assert that the federal anti-fraud provisions were meant to inhibit artificial price levels of shares and that these shares do not fluctuate in price. However, the shares here do fluctuate in value. If the association is successful, the investors' holdings are worth more than the price paid. If, as here, the association is unsuccessful, the shares become worth very little. It is the fluctuation in value of their shares that is important to these shareholders. Even though not always a panacea, the use of the federal anti-fraud provisions would help to guard against [fol. 70] circumstances that would plummet the share value downwards.

The investors in City Savings were less able to protect themselves than the purchasers of orange groves in *Howey*. These plaintiffs had to rely completely on City Savings' management to choose suitable properties on which to make mortgage loans. Cf. *Penfield Co. of California v. Security and Exchange Commission*, 143 F.2d 746, 751 (9th Cir. 1944) certiorari denied, 323 U.S. 768. The members of City Savings were widely scattered. Many of them probably invested in City Savings on the ground that their money would be safer than in stocks. They doubtless expected insurance through the Federal Savings and Loan Insurance Corporation or other sources. Through SEC regulation helpful information would be available to these investors. Through disclosure they would have learned

that City Savings was financially embarrassed and on a limited withdrawal basis, that it had been unable to obtain federal insurance for its shareholders, that its one-year Morocco insurance had not been renewed, and that C. Oran Mensik (whose management had been criticized by the Federal Savings and Loan Insurance Corporation) was connected with City Savings. Instead, City Savings was enabled to speak of its financial strength and to advance reasons why investors should purchase shares therein. Because savings and loan associations are constantly seeking investors through advertising (see, e.g., New Year's Savings & Loan Association Supplement, *Chicago Tribune*, December 27, 1966), the SEC's present tender of its expert services should be especially beneficial to would-be savings and loan investors as a shield against unscrupulous or unqualified promoters. Nothing in the 1934 Act or the cases under the two Acts stands in the way of such anti-fraud protection. The District Court was clearly correct in affording it.

_____, Clerk of the United States
Court of Appeals for the Seventh Circuit.

[fol. 71]

IN THE UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

Before Hon. Win G. Knoch, Circuit Judge, Hon. Roger
J. Kiley, Circuit Judge, Hon. Walter J. Cummings, Jr.,
Circuit Judge.

Nos. 15631, 15633, 15634

ALEXANDER TCHEREPNIN, et al., Plaintiffs-Appellees,

vs.

JOSEPH E. KNIGHT, Director of Department of Financial
Institutions, et al., Defendants-Appellants.

Appeals from the United States District Court for the
Northern District of Illinois, Eastern Division.

JUDGMENT—January 20, 1967

This cause came on to be heard on the transcript of the
record from the United States District Court for the
Northern District of Illinois, Eastern Division, and was
argued by counsel.

On consideration whereof, it is ordered and adjudged
by this court that the decision of the said District Court
in this cause appealed from be, and the same is hereby,
Reversed, with costs, and that this cause be, and it is
hereby, Remanded to the said District Court with instruc-
tions to dismiss the Complaint, in accordance with the
opinion of this Court filed this day.

[fol. 72] Clerk's Certificate to foregoing papers (omitted
in printing).

[fol. 73]

SUPREME COURT OF THE UNITED STATES

No. 1301, October Term, 1966

ALEXANDER TCHEREPNIN, et al., Petitioners,

v.

JOSEPH E. KNIGHT, et al.

ORDER ALLOWING CERTIORARI—June 5, 1967

The petition herein for a writ of certiorari to the United States Court of Appeals for the Seventh Circuit is granted.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

APR 20 1967

IN THE

Supreme Court of the United States vs, CLERK

OCTOBER TERM, 1966

No. ~~1301~~ 104

ALEXANDER TCHEREPNIN, MING TCHEREPNIN,
CHARLES NOLL, MAYBELLE NOLL, HARRY BLOCK,
JEANETTE A. BLOCK, WERNER D. BLOCK, ADRIAN
DA PRATO, PETER DA PRATO, FREDERICK D. WAHL,
ANNE W. WAHL, THEODORE MACHATKA, MARIE B.
MACHATKA, JOSEPH NOVAK, FRANCES NOVAK, MARY-
BETH SIMJACK, WALTER R. ANDERSON AND HELEN
K. KELLOGG,

Petitioners,

vs.

JOSEPH E. KNIGHT, JUSTIN HULMAN, CITY SAVINGS AS-
SOCIATION, DENNIS KIRBY, HARRY HARTMAN, LOUIS
KWASMAN, ROBERT FRANZ, STANLEY PASKO, JOSEPH
TALARICO, JR., HERBERT J. HOOVER, ROBERT M.
KRAMER, C. ORAN MENSİK AND GLORIA MENSİK
SPRINCZ,

Respondents.

**PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE
SEVENTH CIRCUIT.**

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Counsel for Petitioners.

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IN THE
Supreme Court of the United States

OCTOBER TERM, 1966.

No. _____

ALEXANDER TCHEREPNIN, MING TCHEREPNIN,
CHARLES NOLL, MAYBELLE NOLL, HARRY BLOCK,
JEANETTE A. BLOCK, WERNER D. BLOCK, ADRIAN
DA PRATO, PETER DA PRATO, FREDERICK D. WAHL,
ANNE W. WAHL, THEODORE MACHATKA, MARIE B.
MACHATKA, JOSEPH NOVAK, FRANCES NOVAK, MARY-
BETH SIMJACK, WALTER R. ANDERSON AND HELEN
K. KELLOGG,

Petitioners,

vs.

JOSEPH E. KNIGHT, JUSTIN HULMAN, CITY SAVINGS AS-
SOCIATION, DENNIS KIRBY, HARRY HARTMAN, LOUIS
KWASMAN, ROBERT FRANZ, STANLEY PASKO, JOSEPH
TALARICO, JR., HERBERT J. HOOVER, ROBERT M.
KRAMER, C. ORAN MENSİK AND GLORIA MENSİK
SPRINCZ,

Respondents.

**PETITION FOR A WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS FOR THE
SEVENTH CIRCUIT.**

The petitioners pray that a writ of certiorari issue to
the United States Court of Appeals for the Seventh Cir-
cuit to review the judgment of that Court entered on Janu-
ary 20, 1967, which reversed an order of the District Court
for the Northern District of Illinois denying defendants'
motions to dismiss the complaint for lack of jurisdiction.

OPINIONS BELOW.

The opinion of the United States District Court has not been reported and is printed in the Appendix herein at page 19.

The majority and dissenting opinions of the United States Court of Appeals for the Seventh Circuit are reported in 371 F. 2d 374 and are printed in the Appendix herein at pages 20 and 30 respectively.

JURISDICTION.

The judgment of the Court of Appeals was entered on January 20, 1967 (App. 42, 43).¹ No rehearing was sought by the petitioners.

The jurisdiction of this Court is invoked under 28 U. S. C., § 1254(1).

QUESTIONS PRESENTED.

1. Is a withdrawable capital share issued by a state-chartered savings and loan association "stock," a "transferable share," an "investment contract," a "certificate of interest or participation in a profit-sharing agreement," or otherwise within the definition of "security" contained in Section 3(a)(10) of the Securities Exchange Act of 1934, 15 U. S. C. 78c(a)(10)?

2. Are withdrawable transferable shares in a mutual savings and loan association, which represent its only capital and entitle holders, who are not involved in the association's management, to participate in its net profits (or losses), securities within that definition, so that the anti-

1. "(App. ...)" is hereinafter used to refer to pages of the Appendix to this Petition.

fraud provisions of that Act are applicable to purchases and sales of such shares?²

STATUTES AND REGULATION INVOLVED.

The statutes and regulation which the case involves are:

1. Sections 3(a)(10), (13) and (14) of the Securities Exchange Act of 1934 (15 U. S. C., §§ 78c(a)(10), (13) and (14)).
2. Section 10(b) of the Securities Exchange Act of 1934 (15 U. S. C. § 78j(b)).
3. Section 29(b) of the Securities Exchange Act of 1934 (15 U. S. C. § 78cc(b)).
4. Rule 10b-5 promulgated by the Securities and Exchange Commission under the Securities Exchange Act of 1934 (17 C. F. R. 240, 10b-5).

The full text of these statutes and regulation is set forth in the Appendix, *infra*, pages 43-45.

The Securities Exchange Act of 1934 is hereinafter referred to as "the 1934 Act."

STATEMENT OF THE CASE.

The Nature of the Action.

This is an action pursuant to Sections 10(b) and 29(b) of the 1934 Act (15 U. S. C. §§ 78j(b) and 78cc (b)) and Rule 10b-5 promulgated thereunder (17 C. F. R. 240, 10b-5). Defendants are City Savings Association (hereinafter

2. The complaint alleges that the sales of the shares here were on a restricted basis as to withdrawability (R. 13, 14). Obviously, the questions here presented as to withdrawable shares encompass the subsidiary question whether shares restricted against withdrawability are securities, and such question is comprised in the questions presented. See Rule 23(1)(c) of this Court. Sections 3(a)(13) and (14) of the Securities Exchange Act of 1934 (15 U. S. C. §§ 78c(a) (13) and (14) are involved in that subsidiary question.

"CSA"), its officers, directors and certain other persons. It is brought by about 150 investors in capital shares of CSA, on their own behalf and as a class action on behalf of over 5,000 investors who purchased such shares between July 24, 1959, and June 26, 1964 (R. 5-7, 14, 15).³ They seek to rescind the purchases and to recover the purchase prices paid for the shares of CSA allegedly fraudulently sold to them (R. 8, 16, 17).

CSA is a savings and loan association chartered as a corporation under the Illinois Savings and Loan Act (hereinafter "the Illinois Act") (Ill. Rev. Stats., 1965, C. 32,⁴ §§ 701-944). Under that Act, CSA was granted all general corporate powers, was permitted to carry on the business of a savings and loan association for its shareholders, and was permitted to make, among other investments, real estate and home improvement loans (Ill. Rev. Stats. 1965, C. 32, §§ 702, 791, 792). To secure capital to carry on this business CSA was permitted to and did continuously engage in issuing and selling its capital shares to public investors, including petitioners and the members of the class represented by them (Ill. Rev. Stats., 1965, C. 32, §§ 761, 762),⁵ who thereby assumed the investment risk and the possibility of loss (in this instance estimated to be about 65%). The return, if any, to the investors depends entirely on the success of the directors and the management in investing such capital.

In June, 1964, CSA was seized by the Director of Financial Institutions of Illinois because of its distressed financial condition (R. 13, 15). A month later, upon learning the facts for the first time, petitioners filed this action.

3. Record references are to the Joint Appendix filed in the Court below by respondents City Savings Association, Louis Kwaman, Joseph E. Knight, et al.

4. Chapter 32 of the Illinois Revised Statutes deals with Illinois corporations generally.

5. The complaint alleges that these capital shares were securities (R. 5, 8, 12-14). Respondents did not plead the attributes and

The Amended Complaint Alleges Material Frauds.⁶

1. Material Adverse Information Concerning CSA's Dominant Director and Principal Executive Officer Was Concealed.

At all relevant times, the board of directors of CSA, its policies and activities were dominated and controlled by one C. Oran Mensik. From about 1943 until filing of this action, Mensik was CSA's principal executive officer (R. 16).

Beginning in 1957, Mensik became the subject of a sub-
characteristics of such shares, apparently content to rely on the Illinois statute. That Act provides that such shares are transferable (§§ 761, 768) and shall be evidenced by certificates (§ 768); that the holders share in net profits through dividends, when and if earned, and if declared by the directors (§§ 762, 778, 780); that shareholders may attend annual meetings (§ 743), vote for directors (§§ 742, 744), pass on organic changes, such as amendments of the articles of incorporation (§ 812), mergers (§ 816), sales of all or substantially all assets (§ 821), reorganizations (§ 872) and voluntary liquidations (§ 902), and upon dissolution or liquidation they are to receive their prorata share of the property of the association after payment of its debts (§§ 908, 926).

Petitioners have exhaustively analyzed the federal laws, and the laws of each of the fifty states and of the District of Columbia, relating to savings and loan associations, to determine whether the attributes of withdrawable capital shares of Illinois chartered associations are typical of investors' interests in associations throughout the country. Such research discloses that in almost every jurisdiction, as in Illinois, withdrawable capital interests are authorized to be issued, (a) which constitute capital of the common enterprise, (b) which entitle the investor to share in the profits (or losses) generated (c) solely as a result of efforts of others than the investors; (d) a certificate or account book is required to be issued as evidence of ownership of the investment, (e) the association may be a *mutual*, (f) it is required to be incorporated or chartered by the respective jurisdiction, (g) shareholders may vote on certain fundamental changes in the association, and in most jurisdictions in elections of directors.

6. Since the questions presented were tendered to the courts below by motions to dismiss for lack of subject-matter jurisdiction, the allegations of fact in the complaint must be treated as true. *Radovich v. National Football League*, 352 U. S. 445, 448 (1957); *Guessfeldt v. McGrath*, 342 U. S. 308, 310 (1952); *United States v. New Wrinkle*, 342 U. S. 371, 376 (1952); and *Collins v. Hardyman*, 341 U. S. 651, 652 (1951).

stantial flow of adverse publicity in which he was accused, among many other things, of certain specified misconduct as a director and officer of CSA in breach of his fiduciary duties, and of mismanagement (R. 8-11). In 1959, he was indicted in the U. S. District Court in Maryland on mail fraud charges involving savings and loan associations, and was ultimately convicted (R. 10, 11).

Because Mensik's name, thereafter, was not likely to engender trust and confidence in the minds of prospective CSA shareholders, Mensik and the other directors and officers of CSA in 1959 and continuously thereafter conspired to and did conceal from the investing public, including petitioners, that Mensik was in any way connected with CSA as a director or officer. Such concealment constituted the omission of material facts, the disclosure of which would have caused investors to refrain from investing in the shares which CSA was constantly issuing (R. 11, 12).

2. CSA's Financial Strength Was Misrepresented.

CSA solicited investments in its shares by sales literature mailed to investors in many states of the United States. That literature spoke of the financial strength of CSA and advanced reasons as to the desirability of investing in its shares. However, because CSA's financial policies and management were found to be unsafe, the Federal Home Loan Bank Board had rejected CSA's application for insurance of its shareholders' accounts, thus refusing the insurance customarily provided by that Agency to shareholders of both federal and state chartered savings and loan associations, leaving such accounts uninsured. CSA's sales literature did not disclose such rejection, the reason therefor, or any of such facts. Included in such mail solicitation, among others, were investors in federally

insured savings and loan associations, who in reliance upon such solicitations liquidated such investments and reinvested in CSA shares, thereupon becoming uninsured because of the above-stated non-disclosures (R. 12, 13).

3. CSA Concealed the Withdrawal Restrictions It Had Imposed Because of Its Financial Difficulties.

Beginning in 1957, CSA was in difficulties because its cash commitments far exceeded its cash resources, and it therefore imposed restrictions on withdrawals by investors. A 1959 amendment to the Illinois Act, under such circumstances permitted sales of new investments but prohibited CSA from placing withdrawal restrictions thereon. Nevertheless, after July 23, 1959, CSA contracted to sell restricted withdrawal shares to investors, including petitioners, without disclosing to them that such sales were unlawful, that CSA was on a restricted withdrawal basis, or that it had financial difficulties requiring such restrictions (R. 13, 14).

Respondents' Motions to Dismiss.

Insofar as here pertinent, respondents moved to dismiss the Complaint on the ground that Section 10(b) of the 1934 Act does not apply to fraudulent sales of withdrawable capital shares of savings and loan associations (R. 17-19).⁷

The District Court Sustained the Complaint.

The District Court held that petitioners had entered into "an investment contract and in effect are purchasers of securities within the meaning and provisions of the Exchange Act" (R. 19, App. 19). It certified its order for interlocutory appeal, pursuant to 28 U. S. C. § 1292(b) (App. 20).

7. See also appendix filed in court below by respondents *Franz, et al.*, pp. 22, 23.

The Securities and Exchange Commission Supported Petitioners' Position Below.

The Securities and Exchange Commission (hereinafter "the SEC"), in the District Court and the Court of Appeals, participated as *amicus curiae*, for the stated reasons that the scope and meaning of the term "security" is of fundamental importance to the proper performance of its responsibilities and that the rulings on the questions here involved could affect the Commission's administration of both the Securities Act of 1933 and the 1934 Act. The SEC argued in both courts that the withdrawable capital share in a savings and loan association is a "security" within the meaning of the 1934 Act.

THE DECISION OF THE COURT OF APPEALS.

In rejecting the contentions of petitioners and the SEC, the majority below held that the interest represented by a CSA share could fall within the ambit of § 3(a)(10) of the 1934 Act only if such share was an "instrument commonly known as a 'security'" (App. 24). It concluded that such shares were not so known, and rendered the majority opinion without discussing whether or not such shares are within other definitions of "security" as found in the 1934 Act, including "stock," "certificates of interest or participation in profit-sharing agreement," "transferable share," or "investment contract."

Judge Cummings in a vigorous dissent disagreed with such narrow application of § 3(a)(10) of the Act and pointed out that the term "any instrument commonly known as a security," relied upon by the majority as the basis of its decision, is not, under *Llanos v. United States*, 206 Fed. 2d 852, 854, a limitation upon all of the other definitional categories of the 1934 Act.

REASONS FOR GRANTING THE WRIT.

I.

THE DECISION OF THE COURT OF APPEALS FOR THE 7th CIRCUIT IS IN DEROGATION OF THE BASIC AIMS AND PURPOSES OF THE 1934 ACT AND REMOVES A LARGE SECTOR OF THE NATIONAL ECONOMY FROM ITS ENFORCEMENT AND ADMINISTRATIVE PROVISIONS.

1. The Purpose of the 1934 Act Is to Protect Investors.

The primary aim and purpose of the 1934 Act, as well as of the Securities Act of 1933 (15 U. S. C. 77a *et seq.*), is the protection of the general public and investors, including uninformed, gullible, ignorant and little investors.⁸ *Surowitz v. Hilton Hotels Corporation* (1966), 383 U. S. 363; *Associated Securities Corporation v. Securities and Exchange Commission* (10 Cir., 1961), 293 F. 2d 738, 740; *Berko v. Securities and Exchange Commission* (2 Cir., 1963), 316 F. 2d 137, 141 and cases there cited. The 7th Circuit is in agreement. *Surowitz v. Hilton Hotels Corporation* (1965), 342 F. 2d 596, 602. This protection extends to all securities, whether registered or not, involved in transactions in which the mails or other instrumentalities of interstate commerce are used (§ 10(b)), and whether such transactions take place on a stock exchange or in a stock handling business or elsewhere. *Fratt v. Robinson* (9 Cir., 1953), 203 F. 2d 627, 630, 631; *Kardon v. National Gypsum Co.* (D. C. E. D. Pa., 1946), 69 F. Supp. 512.

8. Judge Cummings eloquently sets forth how the aims and purposes of the 1934 Act are served by the application of that Act "to the typical savings and loan account-holder [who] is a small investor, as unwary and in need of protection as a typical, unsophisticated holder of corporate stock" (App. 41, 42).

2. The Questions Presented Have National Scope.

In the instant case, there are about 150 petitioners and approximately 5,000 holders of capital shares in the class represented by them. In addition, the holders of like shares constitute an immense segment of the national economy. As of December 31, 1964 (the latest date for which statistics are available), throughout the United States there were 38,853,912 separate capital share accounts invested in savings and loan associations, aggregating over \$102 billion. *United States Savings and Loan League, 1965 Annals*, pp. 244, 250. Such withdrawable capital shares throughout the nation are typified by the same general characteristics and attributes as those here involved.⁹ Therefore, the majority decision below has countrywide impact in holding that, regardless of the characteristics and attributes hereinabove set forth, pp. 4 and 5, such capital shares are not securities within the definition of the 1934 Act. Millions of present and future holders of such shares, as well as untold numbers of holders of many other types of securities not "commonly known" as such, by this decision would be deprived of the protections against fraud and misrepresentation afforded by the 1934 Act to investors in other securities.

3. The Decision Below Frustrates to a Substantial Degree the Enforcement and Administration of the 1934 Act by Constricting the Statutory Definition of "Security".

The importance of the question here presented to the enforcement and administration of the 1934 Act is demonstrated by the fact that the statutory terms which give rise to the questions here presented are definitional, and

9. Cf. *Legal Bulletin of the United States Savings and Loan League*, July 1962, pp. 129-234.

the extent of the application of the entire Act depends upon the interpretation of those terms. Judge Cummings' dissenting opinion decries the unjustifiably narrow interpretation of § 3(a)(10) by the majority below and the consequent harmful effect on the broad remedial purposes of the 1934 Act (App. 33-35). He could not accept the majority's rejection of the liberal, flexible tests laid down by this Court in defining "security." *Securities and Exchange Commission v. Joiner Corporation*, 320 U. S. 344 (1943); *Securities and Exchange Commission v. W. J. Howey Company*, 328 U. S. 293 (1946); *Securities and Exchange Commission v. Variable Annuity Life Insurance Company of America*, 359 U. S. 65 (1959) and *Securities and Exchange Commission v. Capital Gains Research Bureau*, 375 U. S. 180 (1963).¹⁰

It becomes immediately apparent that once the breadth of the statutory definition is cut down by excluding any interest not commonly known as a "security", the enforcement of the Act is correspondingly curtailed, restricted and frustrated. If the interpretation by the majority below is permitted to stand, it would serve as a guide to the crafty bent on evolving sophisticated schemes to mulct the

10. Judge Cummings points out that *W. J. Howey* establishes that "the term security embodies a flexible rather than a static principle" in order to meet the "variable schemes devised by those who seek the use of the money of others on the promise of profits" and that *Variable Annuities* and *Joiner* indicate that the 1933 and 1934 Acts are to be "liberally construed in view of their remedial purpose" (App. 33-35). He is therefore critical of the majority interpretation limited solely to whether or not a CSA capital share is "an instrument commonly known as a security" (App. 34). In arriving at his decision that CSA capital shares are securities, Judge Cummings considered additional categories of securities set forth in Section 3(a)(10) of the Act, including "investment contract," "stock," "transferable share" and a "certificate of interest or participation in a profit-sharing agreement" (App. 34). He pointed out that "the clause in Section 3(a)(10) referring to 'in general any instrument commonly known as a security'" is not a limitation upon the preceding categories. *Llanos v. United States*, 206 F. 2d 852, 854 (9th Cir., 1953)." (App. 34.)

investing public by circumventing the protections to investors provided by Congress when it enacted the 1934 Act.

The enforcement and administration of that Act in the public interest are primarily lodged with the SEC, *Berko*, p. 141, but in addition thereto, private litigants, such as petitioners, are given a right of action under § 10(b) against those allegedly defrauding them, *Fratt*, pp. 631-33. Such investors thus become ancillary enforcers of the 1934 Act and function independently of the SEC in achieving the Act's broad social policies. To a very considerable extent, potential violators are deterred from illegal and possibly criminal conduct by the knowledge that any individual investor can call them to account. The beneficial effect of such private enforcement has long been recognized in anti-trust litigation. *Monarch Life Insurance Company v. Loyal Protective Life Insurance Company* (2 Cir., 1963), 326 F. 2d 841, 846; *Osborne v. Sinclair Refining Company* (4 Cir., 1963), 324 F. 2d 566, 572; *C. I. R. v. Obear-Nester Glass Corporation* (7 Cir., 1954), 217 F. 2d 56, 61; *Maltz v. Sax* (7 Cir., 1943), 134 F. 2d 2, 4.

Had the decision of the Court below been limited to interests with the characteristics of which CSA capital shares are typical, the impact nationwide on all investors in withdrawable capital shares of savings and loan associations would have been serious enough to warrant review here; but the opinion below is of wider scope. The broad swath cut through the statutory definition by the decision below, in holding that the 1934 Act applies only to an interest "commonly known" as a "security", leaves standing few of the definitional principles enunciated by this Court during the past thirty years since Congress defined "security" in the Securities Act of 1933. Such long-established principles are equally applicable to interpretation of the 1934 Act, as shown hereinafter in point II, but have been rejected by the Court below.

II.

THE COURT OF APPEALS' DECISION IS IN CONFLICT WITH PRINCIPLES ESTABLISHED BY PRIOR DECISIONS OF THIS COURT.

It is Petitioners' position that the decisions of this Court interpreting the definition of "security" in the Securities Act of 1933 establish principles which must be followed in interpreting the definition of "security" in the 1934 Act.

In *S. E. C. v. C. M. Joiner Leasing Corp.*, 320 U. S. 344 (1943), this Court said that the meaning of "security" within the Securities Act of 1933 "does not stop with the obvious and common-place" and that, to carry out the legislative policy of protecting little investors against devices "widely offered . . . under terms or courses of dealing which established their character in commerce as 'investment contracts'" must be considered "securities" within the reach of the Act. Accordingly, oil and gas leases were held to be "securities" even though not commonly recognized as such or traded on securities exchanges or in established over-the-counter markets.

In *S. E. C. v. W. J. Howey Co.*, 328 U. S. 293 (1946), this Court established that Congress's express inclusion of any "investment contract" in the definition of "security" in the Securities Act of 1933 demonstrated a legislative intention that any "contract or scheme for 'the placing of capital or laying out of money in a way intended to secure income or profit from its employment'" are "investment contract" securities, and "situations where individuals were led to invest money in a common enterprise with the expectation that they would earn a profit solely through the efforts of the promoter or of someone other than themselves" are subject to the 1933 Act. Applying that principle, this Court held that "units of a citrus grove devel-

opment coupled with a contract for cultivating, marketing and remitting the net proceeds to the investor" were "securities", again, even though not commonly recognized as such nor traded on securities exchanges or in established over-the-counter markets.

In *S. E. C. v. Variable Annuity Life Insurance Company*, 359 U. S. 65 (1959), the Court held, per Mr. Justice Douglas, that variable annuities which give the annuitant an "indirect interest in equities" and place the risk of portfolio losses ultimately on the holder are "securities" subject to the 1933 Act. As the concurring opinion of Justice Brennan pointed out, an interest is a "security" where repayment depends on the condition of the investment portfolio.

Although the *Joiner*, *Howey* and *Variable Annuity* cases involved the definition of "security" under the 1933 Act, the principles of interpretation and the interpretation established in these cases are equally applicable to the definition of "security" in the 1934 Act. In the first place, the language of both statutes is substantially identical. Indeed, the statutory definition of a "security" in the 1934 Act, Section 3(a)(10) is identical to the definition in the 1933 Act in including within its coverage *inter alia*, any "stock . . . certificate of interest or participation in any profit-sharing agreement . . . transferable share, investment contract, or, in general, any instrument commonly known as a security . . .". That the two statutes are to be read *in pari materia* is further established by the *Howey* opinion. The Court there observed that "By including the term investment contract within the scope of § 2(1) of the Securities Act Congress was using a term the meaning of which had been crystallized by this prior judicial interpretation" of that very term. 328 U. S. at 298. It is equally apparent that, by including the term "security" in the 1934 Act and by including in its statutory definition interests, such as investment contract, identical to the interests encom-

passed by that term in the 1933 Act, Congress is using a term the meaning of which had been crystallized by Congress itself the year before.

Given the characteristics of petitioners' interests in CSA, the decision and reasoning of the majority below is plainly in conflict with the principles laid down in *Joiner*, *Howey* and *Variable Annuity*. The petitioners' interests in CSA are referred to in the applicable corporate law as "shares" (Ill. Rev. Stats., 1965, C. 32, § 761).

Purchasers of these shares are referred to as "holders," (§ 773), the shares are required by statute to be evidenced by one or more certificates" (§ 768(a)), and are transferable by assignment (§ 768(b)). The capital derived by the association through sales of its shares, is invested by the management of the association at the risk of investors, so that if management fails to produce a profit the investors suffer the loss.

CSA, like other similar associations, vigorously solicited the entire public to invest savings in its capital shares and then reinvested the resulting and often small individual investments in, *inter alia*, real estate mortgages, municipal securities and other "marketable investment securities" (§§ 791, 792). CSA's investments were selected and made by decision solely of CSA's board of directors and officers. If those investments turned out to be unwise or unsound, petitioners and other CSA capital shareholders stood to lose their investments—in many cases, the savings of a lifetime. The investment risk was theirs alone, a critical factor, as observed by Mr. Justice Brennan in *Variable Annuity*, 359 U. S. at 77-80.

Judge Cummings points out that the oil leases in *Joiner*, the citrus grove units in *Howey*, the variable annuities in *Variable Annuity* and the interests in fishing boats, automobile trailers, vending machines, parking meters, ceme-

tery lots, tung trees, vineyards, fig orchards, farm lands and patent rights have been held to be "securities" in decisions of lower federal courts, see *e.g.*, 1 Loss, *Securities Regulation* (2 ed. 1961), pp. 490-91 and 1962 Supplement p. 30 (App. 34). So here, the attributes of petitioners' capital shares in CSA established their character in commerce as "investment contracts" and thus as securities subject to the 1934 Act.¹¹

By narrowing the definition of "security" and thereby refusing to find that the interests before the Court are "investment contracts," the decision below is in conflict with the *Howey* interpretation of "investment contract". To paraphrase *Howey*, petitioners and other CSA investors placed capital or laid out money in a way to secure income

11. When the first federal securities law was enacted in 1933, the Secretary of the United States Building and Loan League advised its member associations that they were "subject to the fraud provisions" of that Act—something which would only have been true if he and the League had understood shares in member associations to be "securities." See *Building and Loan Annals* (1933), pp. 564-65. See also Richards, *The Federal Securities Act*, *Building and Loan Annals* (1933), pp. 111, 115-118. More recently, the United States Savings and Loan League has promoted purchases of savings and loan association shares identical to those purchased by petitioners by publicizing such shares as qualified "securities" or "investments" for trustees, guardians, estates and other fiduciaries. See *Savings and Loan Accounts as Legal Investments*, a research staff article in *Legal Bulletin of the U. S. Savings and Loan League* (July 1962). The Illinois legislature understands plaintiffs' interests to be "securities" by expressly describing them as "securities" in the Illinois Blue Sky Law since 1919. (Rev. Stat. Ill. 1919, Hurd c. 121a, 86 § 5(3); Ill. Rev. Stat. 1951, c. 121½, § 99(2); Ill. Rev. Stat. 1965, c. 121½, § 137.3), and by specifically exempting them along with certain other specified securities such as those listed on certain registered exchanges, from the "securities" made subject to Article 8 of the Uniform Commercial Code. Finally, decisions of lower federal courts have reaffirmed that savings and loan association shares are commonly recognized as investment contracts or securities. Cf. *Wisconsin Bankers Association v. Robertson*, 294 F. 2d 714 (D. C. Cir. 1961); *S. E. C. v. American International Savings and Loan Ass'n.*, 199 F. Supp. 341 (D. Md. 1961); *United States v. Hopps*, 215 F. Supp. 734, 754 (D. Md. (1962)), *aff'd*, 331 F. 2d 332 (4th Cir. 1964).

or profit (in the form of dividends) from its employment, "where individuals were led to invest money in a common enterprise with the expectation that they would earn a profit solely through the efforts of . . . someone other than themselves," i.e., the board of directors and officers of CSA (§28 U. S. at 298).

On the other hand, immediate withdrawability and certain other attributes cited by the majority as uncommon to securities merely demonstrate that those interests are similar to mutual fund shares. As pointed out by Judge Cummings, mutual fund shares are of course "securities" subject to the anti-fraud provisions of the 1933 and 1934 Acts" (App. 38).

CONCLUSION.

Judge Cummings' well reasoned opinion demonstrates the need for review by this Court of the majority opinion below. For the reasons therein and hereinabove stated, the petitioners pray that this petition for a writ of certiorari be granted.

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APPENDIX.

MEMORANDUM AND ORDER OF THE UNITED STATES DISTRICT COURT.

Memorandum and Order of the United States District
Court (Chief Judge Campbell), March 22, 1966:

* * * * *

"... When initially making my decision to assume jurisdiction over this case I was faced with deciding what I acknowledged to be a difficult, far reaching and close legal issue of first impression. I refer to the issue of whether or not Illinois savings and loan depositors or investors enter into an investment contract and in effect are purchasers of securities within the meaning and provisions of the Exchange Act. 15 U. S. C. 78a, *et seq.*

Normally, when making such an important interlocutory decision without the benefit of some prior judicial authorities, preferably from our own Seventh Circuit, I have looked with favor upon motions requesting a § 1292(b) interlocutory appeal. (*Radiant Burners Inc. v. American Gas Association et al.*, 207 F. Supp. 771 and 209 F. Supp. 321, Rev. in 320 F. 2d 314, cert. den. 375 U. S. 929.) However, in the instant case I denied defendants' motions requesting permission to file such an interlocutory appeal. In denying defendants' motions I explained that my main concern was the plight of the individual investors. (Transcript of Proceedings, January 21, 1966, pp. 17-20.)

Then, as now, their protection and the expeditious resolution of all of the issues presently standing in the way of

a final and fair total liquidation of City Savings and Loan Association was my objective. I was then impressed, as I am now even more impressed, with what appears to be a confusion in efforts, possible conflicting interests, and the possible resulting subjugating of investors' claims to the interests of others. A final and total resolution and payment of investors claims appears long overdue.

Further, on my own motion and for the reasons detailed above I now certify that my Order of January 17, 1966 assuming jurisdiction over this case and in effect holding that withdrawable capital shares in a savings and loan association are securities within the meaning of the Exchange Act also "... involves a controlling question of law as to which there is substantial ground for difference of opinion and that an immediate appeal from the order may materially advance the ultimate termination of the litigation...". (Title 28 U. S. C. 1294(b).)

In its present posture I express the hope that my ruling on the main issue concerning the scope and meaning of the term "security" will be reviewed and the law of this Circuit determined by our Seventh Circuit Court of Appeals.

**MAJORITY OPINION OF THE COURT OF APPEALS FOR THE
SEVENTH CIRCUIT, JANUARY 20, 1967.**

KNOCH, Circuit Judge. The City Savings Association, an Illinois savings and loan association, is now in process of voluntary liquidation. When this Complaint was filed in the United States District Court, the Association was in the custody of the defendant, Joseph E. Knight, Director of Financial Institutions of the State of Illinois.

He had assumed custody on June 26, 1964, under authority of the Illinois Savings and Loan Act, Illinois Revised Statutes, Chapter 32 § 848. The defendant Justin Hulman is the Supervisor of the Savings and Loan Division of the Department of Financial Institutions.

At a special meeting on July 28, 1964, the shareholders of City Savings approved a plan of voluntary liquidation and elected the defendants Louis Kwasman, Harry Hartman and Dennis Kirby liquidators to carry out the plan which was approved by the Department of Financial Institutions as evidenced by a certificate filed with the Cook County Recorder of Deeds on August 7, 1964, at which time the plan became effective.

Meanwhile, on July 24, 1964, this action was filed by the plaintiffs-appellees, Alexander Tcherepnin, Ming Tcherepnin, et al., who describe themselves as purchasers, at various dates, of securities issued by City Savings, consisting of capital shares of and a capital interest in City Savings.

Under the Illinois Savings and Loan Act, Illinois Revised Statutes, Chapter 32, §§ 701-944, an association unable to meet its cash commitments could limit the amount of cash a depositor might withdraw [§ 773(b)] as City Savings did in 1958. It was then prohibited from accepting new deposits. The Act was amended on July 9, 1959 [§ 773 (h)] to allow acceptance of new deposits on which it was prohibited to place limitations of withdrawal.

The accounts represented by the plaintiffs according to the Complaint were all opened under the 1959 amendments and hence are fully withdrawable despite the conclusory assertions in the Complaint that plaintiffs purchased their shares on a restricted withdrawal basis.

The plaintiffs brought this action for themselves and all other persons who made deposits in City Savings since July

23, 1959, to have their purchases of shares declared void and to be declared creditors of City Savings.

They invoked jurisdiction of the District Court under § 27 of the Securities Exchange Act of 1934 (Title 15, U. S. C. § 78aa). Diversity of citizenship is lacking here. In addition to those noted above, the Complaint lists as defendants: the City Savings Association, and certain of its former officers and directors.

The Securities and Exchange Commission was allowed to intervene as *amicus curiae*. A group purporting to represent other depositors was allowed to enter the case as party-defendants.

The Complaint alleged that in making their deposits the plaintiffs relied on false and misleading solicitations mailed to them in violation of § 10(b) of the Securities Exchange Act of 1934, and of the General Rules and Regulations promulgated thereunder, which rendered their purchases void under § 29(b) of the Act entitling them to rescind their investments and to recover the amount of their investments plus interest.

The defendants City Savings and the three liquidators moved to dismiss the Complaint for lack of jurisdiction in the District Court because the subjects of the action—withdrawable capital accounts of a state-chartered savings and loan association—were not “securities” within the meaning of the Act. The other defendants also moved to dismiss the action. All the motions were denied.

The question presented by denial of motion to dismiss was certified by the District Court under § 1292(b) of the Judicial Code (Title 18 U. S. C. § 1292(b)). This Court granted petition for leave to file interlocutory appeal.

We are thus presented with one contested issue: is a withdrawable capital account in an Illinois-chartered savings and loan association a “security” within the meaning

of that term as it is used in the Securities Exchange Act of 1934?

The plaintiffs-appellees and the Securities and Exchange Commission, which has filed its brief in these cases as *amicus curiae*, both assure us that a withdrawable capital account in an Illinois-chartered savings and loan association is such a "security"; that Congress intended to include such accounts within the broad definition of the Act, particularly as shown by subsequent amendments. They also point to court decisions classifying as "securities" some interests which possess some similar characteristics, which they view as the fundamental characteristics of these accounts. On the other hand, they see the other rather strikingly distinctive characteristics of these accounts, on which the appellants rely, as not fundamental but as merely subsidiary, some of even these being also present in other interests which have been accepted as securities.

The Act provides the following definition of a "security":

"The term 'security' means any note, stock, treasury stock, bond debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a security; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding 9 months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited." Securities Exchange Act of 1934, § 3(a)(10), 15 U. S. C. § 78c(a)(10).

The type of interest now before us, if it is covered by this definition, must be "an instrument commonly known as a security."

The report accompanying the predecessor Act, cited as the Securities Act of 1933, noted that the term "security" was so defined as to include the many types of instruments which in the commercial world fell within the "ordinary concept of a security." H. R. Rep. No. 85, 73rd Cong., 1st Sess. 5/4/33 p. 11.

As appellants state, these accounts are unlike the ordinary concept of a security in such characteristics as being permissibly issued in unlimited amounts; as not made subject to the securities article of the Uniform Commercial Code; as not negotiable and transferable only by assignment; as subject to forced redemption and retirement on call of the board of directors; as fully matured and withdrawable when issued; as without preemptive rights; as evidenced by an account book, the holders of which are not entitled to inspect the general books and records of the association; although entitled to vote for directors, to give a proxy which may (and usually does) provide that it is irrevocable and which is typically executed when the account is opened, and to receive dividends.

The Illinois statutes which created withdrawable accounts in savings and loan associations show clearly that the Illinois legislature did not intend them to be securities. It thus seems difficult to assert that these interests can be "commonly known as a security."

According to its preamble, the Securities Exchange Act is designed to regulate transactions in securities as commonly conducted on securities exchanges and over-the-counter markets, the price of such securities being susceptible to manipulation and control and the dissemination of such prices giving rise to excessive speculation resulting in

sudden and unreasonable fluctuations in the prices of securities.

The 1934 Act expressly excludes debtor-creditor relationships represented by notes maturing in nine months of issuance. The interest with which we are concerned is mature at issue.

The Federal Bankruptcy Act, Title 11 U. S. C. § 22, exempts State building and loan associations from federal bankruptcy adjudication. See *Security Building & Loan Assn. v. Spurlock*, 9 Cir., 1933, 65 F. 2d 768, 771, where the Court quotes extensively with approval from Rep. 98, 72d Congress, 1st sess. House Judiciary Committee; House Reports 2-659, 72d Cong. 1st sess., indicating Congressional determination to leave the administration of State created building and loan associations in the local courts. We may assume that City Savings would be exempt from the provisions of the Bankruptcy Act. *Home Savings and Loan Assn. v. Plass*, 9 Cir., 1932, 57 F. 2d 117.

In *S. E. C. v. Joiner Corp.*, 320 U. S. 344, 352-3 (1943), the Court was considering whether assignments of oil leases were securities under the Act. In that connection the Court said:

The test rather is what character the instrument is given in commerce by the terms of the offer, the plan of distribution, and the economic inducements held out to the prospect.

At another point (p. 351) the Court said:

[T]he term "security" was defined to include . . . documents in which there is common trading for speculation or investment.

In *S. E. C. v. Howey Co.*, 328 U. S. 293 (1946) the Court said:

The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others.

An "investor" in a savings and loan association lends his money to be withdrawable at will and to earn interest. The relationship with the enterprise is much more that of debtor-creditor than investment. The profit is derived from loans to other members of the savings and loan association. This is not investment in a common enterprise with profits to come solely from the efforts of others.

The Securities Act of 1933 and the Securities Exchange Act of 1934 were passed in the aftermath of the great economic disaster of 1929. Congress was concerned with speculation in securities which had a fluctuating value and which were traded in securities exchanges or in over-the-counter markets.

The S. E. C. relies heavily on a recent amendment. Section 12(g), Title 15 U. S. C. § 78 1* (g), provides for registration of certain equity securities. There is a specific exemption of "any security [with certain exceptions not pertinent here] issued by a savings and loan association" §-12(g) (2) (C). The S. E. C. thus argues that the definition of "security", *supra*, must include interests which are referred to as securities in this exemption.

If these interests were already excluded by the definition, the Commission argues, then the exemption would be meaningless or would have to be interpreted as referring to some other undefined security of a savings and loan association.

In its Technical Statement on H. R. 6789, H. R. 6793, and S. 1642, submitted at the Hearings before a Sub-committee of the Committee on Interstate and Foreign Commerce; House of Representatives, 88th Congress, 1st Session (1963), p. 215, the S. E. C., while referring to all other interests which it recommended for exemption as being "securities", speaks of "share accounts" when referring

* Lower case letter L.

to the savings and loan associations, suggesting that a distinctive view was held of these interests by the Commission itself.

The S. E. C. sees no significance in the omitting from the definition in the 1934 Act of the term "evidence of indebtedness" which does appear in the definition in the 1933 Act. These Acts were considered to have been substantially the same. The S. E. C. sees the omission as merely indicative of a different draftsman.

The Commission also notes that there was apparently no discussion of savings and loan interests at the time the 1934 Act was passed.

However, appellants invite our attention to the lengthy consideration of the term "evidence of indebtedness" in connection with the 1933 Act. (Hearings on S. 875 before Senate Committee on Banking and Currency, 73rd Cong. 1st sess., pp. 94-120 *passim*.)

Some of the Senators evidently saw a relationship between this term "evidence of indebtedness" and accounts in building and loan associations as well as between the term and various short term banking transactions. There was some fear that the 1933 Act would interfere with ordinary commercial banking transactions. The term was retained but certain short-term debtor-creditor transactions were exempted. The same Congress which in 1933 had been considering the relationship between the term "evidence of indebtedness" and accounts in building and loan associations, excluded that term from the 1934 Act, retaining only such evidences of indebtedness as long-term notes, bonds and debentures. Yet the Investment Act of 1940, Title 15 U. S. C. § 80a-2 (35), for example, retains the term in its definition of "security". Congress must have had some intention of excluding those interests which fell under the broad character of "evidence of indebtedness."

The definitions set out in the Act are all preceded by an introductory statement that they apply "unless the context otherwise requires."

Perhaps insurance policies may provide a useful analogy. In discussing mutual insurance companies over whom the S. E. C. does not claim jurisdiction, Chairman William L. Cary of the S. E. C. said:

[W]e do say that mutual insurance companies are not included under this bill because the buyers in mutual insurance companies are fundamentally buying insurance. * * * and not stock. Furthermore, because there is no stock, there is no trading in the stock. (House Hearings, 1963, *supra*, p. 309.)

Basically that distinction applies to holders of "share accounts" in savings and loan associations. There is no stock or trading in stock.

A little later, Chairman Cary said:

[S]ince the holders in mutual companies are policy holders, any wrongdoing would be the responsibility of the State superintendent of insurance.

With respect to City Savings, also, the local State authorities are ready and able to handle the orderly disposition of the institution's liquidation.

Insurance policies were exempted from the Securities Act of 1933 [Title 15 U. S. C. § 77c(a) (8)] and under the 1964 amendments [Title 15 U. S. C. § 78 1* (g) (2) (G)]. Are they necessarily included in the definition of "securities"?

Professor Loss (*Securities Regulation*, 2d ed. 1961, p. 497) says that on its face the exemption of insurance policies in the 1933 Act seems to create a negative implication that insurance policies are securities which may be exempt from registration but are subject to the anti-fraud pro-

* Lower case letter L.

visions. He observes that the Commission takes the position with respect to insurance policies that they are not intended to be "securities".

Chairman Cary advised, in the course of the Hearings before the Subcommittee in 1963, *supra*, p. 300, that while his Commission regulated offering of variable annuities as an offering of securities subject to the 1933 Act, he wanted to emphasize the fact that it was only the investment company operation that was regulated; that "we don't touch the insurance operations that they may have."

Professor Loss also notes that the House Report states that the purpose of the exemption is to make clear what was implied in the Act, that insurance policies are not to be regarded as securities subject to the provisions of the Act. See H. R. Rep. 85, 73rd Cong., 1st sess. (1933) 15, cited in *S. E. C. v. Variable Annuity Co.*, 359 U. S. 65, 74, n. 4 (1959) in Justice Brennan's concurring opinion, where he states that under the Securities Act of 1933, it would appear that for ordinary insurance policies the exemption is just confirmatory of the policy's non-coverage under the definition of security.

H. R. Rept. 85 states that:

The entire tenor of the act would lead, even without this specific exemption, to the exclusion of insurance policies from the provisions of the act, but the specific exemption is included to make misinterpretation impossible.

It seems likely that the specific exemption of the interest here under consideration was also inserted for the same reason. This seems a more reasonable interpretation than that urged on us by the appellees and the Commission.

The appellees and the Commission cite a number of cases from which we are invited to draw analogies favorable to their view. However, these deal largely with the 1933 Act

which included the broad term "evidence of indebtedness" which, as indicated, was excluded from the 1934 Act with which we are here concerned, or which are otherwise not directly helpful. Neither the parties nor this Court has found a case directly in point.

We have carefully considered all other arguments advanced and have studied all authorities cited. It is our opinion that these interests are not encompassed in the definition of a "security" under the 1934 Act; that the anti-fraud provisions of that Act are not here applicable; and that the District Court lacked jurisdiction of this cause.

The decision of the District Court is therefore reversed and the cause is remanded with instructions to dismiss the Complaint.

REVERSED AND REMANDED
WITH INSTRUCTIONS.

DISSENTING OPINION OF JUDGE CUMMINGS.

CUMMINGS, *Circuit Judge* (dissenting). My conclusion is that Chief Judge Campbell of the District Court correctly held that withdrawable capital shares¹ in Illinois savings and loan associations are "securities" within the meaning of Section 3(a) (10) of the Securities Exchange Act of 1934 (15 USC § 78c(a) (10)), so that the anti-fraud provisions of that statute are applicable to this case. Savings and loan passbooks typically describe the owners as holding a savings account representing "share interests" in the association. Many associations reserve the right to

1. *Arguendo*, the majority and this dissenting opinion consider these as withdrawable shares in accordance with the then applicable provisions of the Illinois Savings and Loan Act (Ill. Rev. Stat., 1963, c. 32 § 773(h)). However, the complaint alleges that since 1959 the shares were sold on a restricted withdrawal basis. At trial, the District Court would have to determine whether defendants could sell shares restricted against withdrawal. That point has not been considered in this Court.

require 30 days' notice for withdrawals. Insurance, when available through the Federal Savings and Loan Insurance Corporation, gives \$15,000 maximum coverage up to the "full withdrawal or repurchasable value of the accounts of each of its . . . investors . . . holding withdrawable or repurchasable shares" (12 USC § 1728(a)). (*Italics supplied.*)

Section 3(a) (10) is quoted in the majority opinion and defines "security" as including, *inter alia*, any "stock . . . certificate of interest or participation in any profit-sharing agreement . . . transferable share, [or] investment contract". This definition is substantially the same as that contained in Section 2(1) of the Securities Act of 1933 (15 USC § 77b (1)), so that the legislative history and judicial construction of the definition in the Securities Act lend meaning to the definition in the complementary 1934 Act.

In enacting the Securities Act of 1933, Congress exempted "any *security* issued by a . . . savings and loan association" from the registration provisions while subjecting them to the fraud provisions of that statute (15 USC §§ 77c(a) (5) and 77q(a) and (c)). (*Italics supplied.*) While the savings and loan industry representatives were desirous of an exemption from the registration provisions of the 1933 Act, their spokesman, the late Morton Bodfish, supported the application of the anti-fraud provisions of the statute to the issuance of savings and loan shares, which he described *passim* as securities.² This specific exemption shows that when Congress wished to exclude savings and loan accounts, it knew how to do so. It has never chosen to exclude them from the anti-fraud requirements of the

² Hearings on H. R. 4314 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 1st Sess., pp. 72-74. See also Hearings on S. 875 before the Senate Committee on Banking and Currency, 73d Cong., 1st Sess., pp. 50-54 (1933); Richards, *The Federal Securities Act*, Building and Loan Annals (1933), pp. 111, 115-118.

1934 Act. The majority opinion relies on the securities exemption of ordinary insurance policies under the 1933 Act, but they differ from the withdrawable capital accounts because they possess none of the attributes of securities. As Professor Loss observes, the exemption of insurance policies was supererogation due to an excess of caution. 1 Loss, *Securities Regulation* (2d ed. 1961), pp. 496-497. Therefore their exemption does not show they are subject to the anti-fraud requirements of the 1933 Act, particularly since the 1933 legislative history shows that they were "not to be regarded as securities" (*idem*).

When Congress enacted the Securities Exchange Act of 1934, there was no discussion of savings and loan interests during the consideration of the definition of a security in that Act.³ However, in 1964, in amending the 1934 Act by providing for the registration of equity securities by certain issuers, Congress exempted "any security * * * issued by a savings and loan association" from the new registration provisions (15 USC § 781(g)(2)(C). (Italics supplied.) The then Chairman of the Securities and Exchange Commission, William L. Cary, explained the exemption as follows:

"Because of the fact that most savings and loan associations issue so-called shares, which in fact merely evidence the existence of a savings account, special provision had to be made to exempt that type of 'share'".⁴ No exemption would have been necessary unless shares

3. There has been no showing that the deletion of "evidence of indebtedness" (found in the "security" definition in the 1933 Act) from the 1934 Act's definition of a security was intended to exempt savings and loan accounts. The author of the 1934 Act may have decided that inclusion of "evidence of indebtedness" would be poor draftsmanship, that term being inconsistent with the exclusion of "any note, draft, bill of exchange, or banker's acceptance" (15 USC § 78c(a)(10)).

4. Hearings on H. R. 6789, H. R. 6793 and S. 1642 before a Subcommittee of the House Committee on Interstate and Foreign Commerce, 88th Cong., 1st Sess. p. 1213 (1963).

in savings and loan associations were already within the definition of a security under Section 3(a)(10) of the Securities Exchange Act. This exemption was justified in the Senate Report on the ground that "There is normally no trading interest in the remaining *categories of securities* [including share accounts in savings and loan associations] exempted from the registration provisions." S. Rep. No. 379, 88 Cong., 1st Sess., p. 61 (1963). (Italics supplied.) Thus the Senate Committee on Banking and Currency understood such share accounts to be "securities."

The definition of a "security" in the Securities Act of 1933 was involved in *Security and Exchange Commission v. W. J. Howey Co.*, 328 U. S. 293. The Court said that the term security "embodies a flexible rather than a static principle" in order to meet the "variable schemes devised by those who seek the use of the money of others on the promise of profits" (at p. 299). Therefore, it held that a sale of a parcel of land in citrus groves, when coupled with a contract for management services, was an "investment contract" within the definition of a security under the 1933 Act. In language applicable here, the Court stated (at pp. 298, 299):

"an investment contract for purposes of the Securities Act means a contract, transaction or scheme where a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise."⁵

5. The broad *Howey* formula has been codified into a rule under the Illinois "blue sky" statute. 1 Loss, *Securities Regulation* (2d ed. 1961), pp. 487-488, note 79. Ill. Rev. Stat., 1965, C. 121½, § 137.1-1.

Here too the shareholders in this Illinois savings and loan association invested their money in a common enterprise and were led to expect profits from the efforts of others, viz., the management. As in *Howey*, it is immaterial whether their shares were evidenced by formal certificates. Whether or not plaintiffs' shares are an "investment contract," under the *Howey* case, the Securities Exchange Act applies if they are "stock", a "transferable share" or a "certificate of interest or participation in a profit-sharing agreement." The subsequent clause in Section 3(a)(10) referring to "in general, any investment commonly known as a 'security'" is not a limitation upon the preceding categories. *Llanos v. United States*, 206 F. 2d 852, 854 (9th Cir. 1953) certiorari denied, 346 U. S. 923. It must be remembered that these various categories in Section 3(a)(10) are not mutually exclusive and are meant to be "catchalls". 1 Loss, *Securities Regulation* (2d ed. 1961) pp. 483, 488-489. The breadth of the definition of security in the two Acts is shown by Professor Loss' illustrations of coverage in cases involving animals, fishing boats, automobile trailers, vending machines and parking meters, cemetery lots, tung trees, vineyards, fig orchards, farm lands, and patent rights. 1 Loss, *Securities Regulation* (2d ed. 1961) pp. 490-491 and 1962 Supplement, p. 30. All sorts of schemes, "many of them of the Alice in Wonderland variety", are regulated through "the *Joiner-Howey* process of looking through form to substance" and through the broad definition of "security" found in the two Acts. *Idem*, pp. 488-489. Under the definition of a security under the 1933 and 1934 Acts, a writing is not essential. 1 Loss, *Securities Regulation* (2d ed 1961) pp. 458, 488-489. Moreover, these passbooks would qualify as writings and indeed as certificates "of interest or participation in any profit-sharing agreement" (15 USC § 78c(a)(10)).

As observed in a similar context, it is unnecessary to pigeonhole these withdrawable capital shares into one category of security or the other. Cf. *Securities and Exchange Commission v. Variable Annuity Co.*, 359 U. S. 65, 80 (concurring opinion). In addition to the *Variable Annuity* and *Howey* cases, *Securities and Exchange Commission v. Joiner Corporation*, 320 U. S. 344, indicates that these companion statutes must be liberally construed in view of their remedial purpose. There the "investment contract" part of the security definition in the 1933 Act was deemed applicable to non-standard offerings of variable character (at p. 351). Our Court has also favored a broad construction in *Securities and Exchange Commission v. Crude Oil Corp.*, 93 F. 2d 844, 846 (7th Cir. 1937); and *Securities and Exchange Commission v. Universal Service Corporation*, 106 F. 2d 232, 237 (7th Cir. 1939), certiorari denied, 308 U. S. 824.

7 Although the foregoing cases involved the Securities Act of 1933, the definition of a security in the Securities Exchange Act was involved in *Securities and Exchange Commission v. Los Angeles Trust Deed & Mortgage Exchange*, 186 F. Supp. 830, 886-888 (S. D. Cal. 1960), affirmed in pertinent part, 285 F. 2d 162 (9th Cir. 1960), certiorari denied, 366 U. S. 919. In affirming the District Court's holding that defendant's sales of second trust deeds constituted sales of "securities" within the 1933 and 1934 statutes, the Ninth Circuit noted that "Howey adds the test of *common enterprise* to the Joiner test of *results dependent on the efforts of one other than the purchaser*" (285 F. 2d at p. 168; court's italics). There the defendant selected a trust deed for the investor and serviced it by making the collections from the grantor-debtor and by doing the bookkeeping. Basically the system was very much like a savings and loan association, for funds supplied by investors were used to

finance secured loans on real property. In *Los Angeles Trust Deed*, the investors' money was used to buy a particular deed, whereas savings and loan associations make their loans from commingled savings. This difference satisfies the "common enterprise" *Howey* test even more than the trust deed system in *Los Angeles Trust Deed*. Under that case, the instant plaintiffs' shares clearly represent an "investment contract" within the security definition in the 1934 Act.

In *Securities & Exchange Commission v. American International Savings and Loan Ass'n.*, 199 F. Supp. 341, 346 (D. Md. 1961), the association's articles provided for preferred stock to be known as preferred share or savings share accounts. Deposit books were issued to depositors, who were entitled to receive cumulative dividends of at least 3½% before any dividends were paid to common stockholders. Since the court held that defendants violated the 1933 Act, it necessarily concluded that this preferred stock, which resembled withdrawable capital shares in the City Savings Association, was a security within the purview of the 1933 Act.⁶ Applying *American International* here would mean that these shares qualify as securities under the like definition in the 1934 Act.

A recent Illinois decision involving a savings and loan association also shows that these withdrawable shares are "securities". Thus in *Marshall Savings and Loan Association v. Henson*, 222 N. E. 2d 255 (1966), the Appellate Court of Illinois observed "that the Illinois Savings and Loan Act gives the depositors the status of *shareholders* by conferring one vote for each \$100 on deposit"

6. In *United States v. Hopps*, 215 F. Supp. 734, 754 (D. Md. 1962), affirmed, 331 F. 2d 332 (4th Cir. 1964), certiorari denied, 379 U. S. 820, the same judge described interests in savings and loan associations as "securities".

(italics supplied). There it was held that the Federal Savings and Loan Insurance Corporation, as assignee of Marshall's withdrawable share accounts, had obtained the right to vote the "stock" or "shares" even though Marshall's members had not endorsed their certificates or passbooks to the Federal Savings and Loan Insurance Corporation. Similarly, *Wisconsin Bankers Association v. Robertson*, 294 F. 2d 714 (D. C. Cir. 1961), certiorari denied, 368 U. S. 938, concluded that the holder of a savings account in a savings and loan association was a shareholder and not a creditor of the association, and that such associations were not banks. The concurring opinion of Judge Burger noted that the owner of a savings and loan association account is an investor and is entitled to vote for management. See also *Aetna Casualty & Surety Company v. Porter*, 296 F. 2d 389 (D. C. Cir. 1961), reversed on other grounds, 370 U. S. 159. As further evidence of the distinction between savings and loan associations and banks, we have been advised that as of December 31, 1965, the mortgage loans of savings and loan associations were 85.14% of their total assets, whereas the comparable percentage for commercial banks was only 13.11%. Banks are in a much more liquid position than those associations, demonstrating that investors in such associations need the disclosures required under the 1934 Act.

The majority opinion and the defendants reason that these withdrawable capital accounts form a "debtor-creditor relationship" and are not investments. This reasoning is contrary to Section 4-13(f) of the Illinois Savings and Loan Act (Ill. Rev. Stat., 1965, c. 32 § 773(f)), which provides:

"The holder of withdrawable capital for which an application for withdrawal has been made, does not

become a creditor by reason of such application." Both the *Wisconsin Bankers* and *Aetna Casualty* cases also hold that a creditor-debtor relationship is not present here. If these shareholders were creditors, they would be entitled to interest. Actually they are entitled to receive only dividends payable out of the association's profits, if any.

To avoid the security definition, appellants emphasize the withdrawability and non-preemptive rights attached to these savings and loan shares, but the same is true of mutual fund shares. They are of course "securities" subject to the anti-fraud provisions of the 1933 and 1934 Acts. Also in truth these savings and loan shares are less "withdrawable" than stocks which can be sold immediately merely by phoning a broker. As to savings and loan shares, the investor may have to wait 30 days or more for withdrawals, and the association may limit the amount of withdrawals (Ill. Rev. Stats. (1965) c. 32 § 773(a) and (b)). If as here, the association has suffered reverses, withdrawability is an empty right. Also, these shareholders' right of redemption and their right to vote for directors, to participate in dividends, and to obtain a certificate of ownership are all common characteristics of securities. It is immaterial that they had no right to inspect City Savings' books and records. Neither do bondholders or holders of such interests as involved in *Howey*, and yet the 1934 Act applies to those categories.

Defendants and the majority opinion assert that these savings and loan interests are not securities because the Illinois Savings and Loan Act provides that they are not subject to Article 8 of the Uniform Commercial Code (Ill. Rev. Stat., 1965, c. 32 § 768(c)). However, if the Illinois Legislature did not consider these accounts to be securities, there would have been no need to exclude them from the

Uniform Commercial Code. The comment on Article 8 of the Uniform Commercial Code recognizes that the definition of security contained in Article 8 is less broad than the Securities Act of 1933, the Securities Exchange Act of 1934, and the Illinois Securities Law of 1953. (See Uniform Commercial Code, Illinois comment, Smith-Hurd Ill. Stats. Ann., c. 26 § 8-102.) It is significant that the Illinois Securities Act of 1953 recognizes withdrawable capital share accounts as securities. Thus that Act affords an exemption to "the following securities: * * * Securities issued by * * * any savings and loan association * * *" (Ill. Rev. Stats., 1965, c. 121½, § 137.3D).

The majority opinion and the defendants also rely on the short-term commercial paper exclusion in the definition of "security" in Section 3(a)(10) of the Securities Exchange Act for "currency, or any note, draft, bill of exchange, or banker's acceptance" having a maturity not exceeding nine months at issuance. Plaintiffs' interests in City Savings are neither currency nor short-term commercial paper of non-investment character and therefore do not fall within this exclusion. Finally, in this connection, Section 4-13(f) of the Illinois Savings and Loan Act (Ill. Rev. Stat., 1965, c. 32 § 773(f)), providing that a holder of withdrawable capital does not become a creditor even upon filing an application for withdrawal, rebuts any argument that plaintiffs' interests were short-term debts within the commercial paper exclusion.

Defendants and the majority opinion point to the savings and loan association exemption in the Federal Bankruptcy Act (11 USC § 22) in an effort to show that Congress intended to exempt such associations from all federal regulation: But railroads, for example, are also exempted from the Bankruptcy Act, and of course their securities are subject to the Securities Act and the Securities Exchange Act.

The exemption of an association from one federal Act certainly does not show that it is to be exempted from the scope of other federal Acts.

The opponents of federal regulation emphasize the non-marketability of these shares, but the scope of the 1934 Act is of course not limited to securities traded on markets. *Schine v. Schine*, 250 F. Supp. 822, 823 (S. D. N. Y. 1966) and cases cited. These shares were transferable,⁷ and at oral argument it was undenied that such shares have been traded over-the-counter. The preamble of the Securities Exchange Act covers the regulation of over-the-counter markets (H. R. 9323, Public No. 291, 73d Cong., 1st Sess. (1934)), and Section 10(b) of the Act reaches manipulative or deceptive devices or contrivances employed in connection with the purchase or sale of any security not registered on a national exchange (15 USC § 78j(b)). Because shares in savings and loan associations are sold on over-the-counter markets, the SEC has required the registration of brokers who deal solely in such shares. In any case, the oil leases, orange groves and variable annuity policies involved in the Supreme Court's *Joiner*, *Howey* and *Variable Annuity* cases were not traded on exchanges or over the counter, and yet all were held to be securities even though they had none of the ordinary characteristics of securities described in the present majority opinion. Also, none of those cases relied on "evidence of indebtedness" as found in the 1933 Act's security definition. Hence the absence of that term from the otherwise similar definition in the 1934 Act does not show that the other terms in the 1934 definition must be given a narrower construction. In that trio of leading cases, it was much more difficult to justify applicability of the federal statute than here, for there was seemingly a strong Congressional policy against federal regulation, less

7. Section 4-8(b) of the Illinois Savings and Loan Act (Ill. Rev. Stat. (1965), c. 32 § 768(b)).

need for investor protection and less statutory support. Here, as seen, the savings and loan industry welcomed the federal anti-fraud umbrella, the investors need federal protection, and the 1934 statutory definitions of a security are clearly broad enough to cover these shares.

Policy considerations also require affirmance of the decision below. The typical savings and loan account-holder is a small investor, as unwary and in need of protection as a typical, unsophisticated holder of corporate stock. Protection is especially warranted here, for compliance with rules and regulations under Section 10(b) of the 1934 Act (15 USC § 78j(b)) would not involve any excessive burden on these associations, nor is there any undue intrusion on State regulation. In fact, the briefs of the Illinois Attorney General point to no comparable Illinois statutory protection and do not show as a matter of federal-state relations why the 1934 Act should not be applied.

Defendants assert that the federal anti-fraud provisions were meant to inhibit artificial price levels of shares and that these shares do not fluctuate in price. However, the shares here do fluctuate in value. If the association is successful, the investors' holdings are worth more than the price paid. If, as here, the association is unsuccessful, the shares become worth very little. It is the fluctuation in value of their shares that is important to these shareholders. Even though not always a panacea, the use of the federal anti-fraud provisions would help to guard against circumstances that would plummet the share value downwards.

The investors in City Savings were less able to protect themselves than the purchasers of orange groves in *Howey*. These plaintiffs had to rely completely on City Savings' management to choose suitable properties on which to make mortgage loans. Cf. *Penfield Co. of California v. Security*

and Exchange Commission, 143 F. 2d 746, 751 (9th Cir. 1944) certiorari denied; 323 U. S. 768. The members of City Savings were widely scattered. Many of them probably invested in City Savings on the ground that their money would be safer than in stocks. They doubtless expected insurance through the Federal Savings and Loan Insurance Corporation or other sources. Through SEC regulation helpful information would be available to these investors. Through disclosure, they would have learned that City Savings was financially embarrassed and on a limited withdrawal basis, that it had been unable to obtain federal insurance for its shareholders, that its one-year Morocco insurance had not been renewed, and that C. Oran Mensik (whose management had been criticized by the Federal Savings and Loan Insurance Corporation) was connected with City Savings. Instead, City Savings was enabled to speak of its financial strength and to advance reasons why investors should purchase shares therein. Because savings and loan associations are constantly seeking investors through advertising (see, e.g., New Year's Savings & Loan Association Supplement, *Chicago Tribune*, December 27, 1966), the SEC's present tender of its expert services should be especially beneficial to would-be savings and loan investors as a shield against unscrupulous or unqualified promoters. Nothing in the 1934 Act or the cases under the two Acts stands in the way of such anti-fraud protection. The District Court was clearly correct in affording it.

JUDGMENT OF COURT OF APPEALS.

This cause came on to be heard on the transcript of the record from the United States District Court for the Northern District of Illinois, Eastern Division, and was argued by counsel.

On consideration whereof, it is ordered and adjudged by this court that the decision of the said District Court in

this cause appealed from be, and the same is hereby, REVERSED, with costs, and that this cause be, and it is hereby, REMANDED to the said District Court with instructions to dismiss the Complaint, in accordance with the opinion of this Court filed this day.

STATUTES AND REGULATION INVOLVED.

Section 10(b) of the Securities Exchange Act of 1934 reads as follows (15 U. S. C. § 78j(h)):

“(10) It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

“(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.”

Rule 10b-5 promulgated by the Securities and Exchange Commission under the Securities Exchange Act of 1934 reads as follows (17 CFR 240, 10b-5):

“It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.”

Sections 3(a)(10), (13) and (14) of the Securities Exchange Act of 1934 read as follows (15 U. S. C., §§ 78c(a)(10), (13) and (14)):

“(3)(a) When used in this title, unless the context otherwise requires—

“(10) The term ‘security’ means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general any instrument commonly known as a ‘security’; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker’s acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.”

“(13) The terms ‘buy’ and ‘purchase’ each include any contract to buy, purchase, or otherwise acquire.”

“(14) The terms ‘sale’ and ‘sell’ each include any contract to sell or otherwise dispose of.”

Section 29(b) of the Securities Exchange Act of 1934 reads as follows (15 U. S. C. § 78cc(b)):

“(b) Every contract made in violation of any provision of this chapter or of any rule or regulation thereunder, and every contract (including any contract for listing a security on an exchange) heretofore or hereafter made, the performance of which involves the violation of, or the continuance of any relationship or practice in violation of, any provision of this chapter or any rule or regulation thereunder, shall be void (1) as regards the rights of any person who, in violation of

any such provision, rule, or regulation, shall have made or engaged in the performance of any such contract, and (2) as regards the rights of any person who, not being a party to such contract, shall have acquired any right thereunder with actual knowledge of the facts by reason of which the making or performance of such contract was in violation of any such provision, rule, or regulation: *Provided*, (A) That no contract shall be void by reason of this subsection because of any violation of any rule or regulation prescribed pursuant to paragraph (2) or (3) of subsection (c) of section 78o of this title, and (B) that no contract shall be deemed to be void by reason of this subsection in any action maintained in reliance upon this subsection, by any person to or for whom any broker or dealer sells, or from or for whom any broker or dealer purchases, a security in violation of any rule or regulation prescribed pursuant to paragraph (1) of subsection (c) of section 78o of this title, unless such action is brought within one year after the discovery that such sale or purchase involves such violation and within three years after such violation."

IN THE

Supreme Court of the United States

OCTOBER TERM, 1966.

NO. 1301

ALEXANDER TCHEREPNIN, MING TCHEREPNIN,
CHARLES NOLL, MAYBELLE NOLL, HARRY
BLOCK, JEANETTE A. BLOCK, WERNER D.
BLOCK, ADRIAN DA PRATO, PETER DA PRATO,
FREDERICK D. WAHL, ANNE W. WAHL, THEO-
DORE MACHATKA, MARIE B. MACHATKA, JO-
SEPH NOVAK, FRANCES NOVAK, MARYBETH
SIMJACK, WALTER R. ANDERSON AND HELEN
K. KELLOGG,

Petitioners,

vs.

JOSEPH E. KNIGHT, JUSTIN HULMAN, CITY SAV-
INGS ASSOCIATION, DENNIS KIRBY, HARRY
HARTMAN, LOUIS KWASMAN, ROBERT FRANZ,
STANLEY PASKO, JOSEPH TALARICO, JR., HER-
BERT J. HOOVER, ROBERT M. KRAMER, C. ORAN
MENSIK AND GLORIA MENSIK SPRINCZ,

Respondents.

(On Petition for a Writ of *Certiorari* to the United States
Court of Appeals for the Seventh Circuit)

**RESPONDENTS KNIGHT'S AND HULMAN'S BRIEF
IN OPPOSITION**

OPINIONS BELOW.

The opinion of the United States District Court has not been reported. It is printed in its entirety in the Joint Appendix filed in the court below at page 34.

The opinion of the United States Court of Appeals for the Seventh Circuit and the dissenting opinion (*App. to Petition*, pp. 20-42) are reported at 371 F.2d 374.

JURISDICTION

The jurisdictional requisites are adequately set forth in the Petition.

QUESTION PRESENTED

Whether a withdrawable capital account in an Illinois-chartered savings and loan association is a "security" within the meaning of that term as it is used in the Securities Exchange Act of 1934?

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the Securities Exchange Act of 1934 (48 Stat. 881, as amended, 15 U.S.C. § 78 a, *et seq.*) and the regulations involved (17 C.F.R. § 240, 10 b-5) are set forth in the Appendix to the Petition filed herein, at pages 43-45, with the exception of Section 2 of the Securities Exchange Act of 1934 (15 U.S.C. § 78 b) which is set forth in the Appendix herein at page 11.

STATEMENT OF THE CASE

The opinion of the Court of Appeals for the Seventh Circuit has adequately set forth the Statement of the Case in the instant action (*App. of Petition*, pp. 20-22).

ARGUMENT

The issue in the present case is narrow and does not warrant review by this Court on *certiorari*. On the interlocutory appeal where the question presented in this case was certified to the Court of Appeals for the Seventh Circuit, the court correctly ruled that withdrawable capital accounts, more commonly known as savings accounts, are not "securities" within the meaning of that term as it is used in the Securities Exchange Act of 1934. Basing its decision on Congressional intent, as drawn from testimony in Congressional hearings and the history of federal regulation of securities the court concluded that the nature of such an account was not intended to be covered by the 1934 Act. Obviously, no important question of federal law requiring decision by this Court is presented by this narrow proposition.

Moreover, there is no asserted conflict of decision anywhere on this limited point. The decision below is consistent with the interpretation of this field by this Court, and the several Courts of Appeals.

REASONS FOR DENYING THE WRIT.

I.

THE DECISION OF THE COURT OF APPEALS FOR THE SEVENTH CIRCUIT IS CLEARLY CORRECT.

The decision of the Court of Appeals, after an exhaustive analysis of federal regulation of the securities industry by Congress and the opinions of this Court relating thereto, concluded that a withdrawable capital ac-

count, more commonly known as a savings account, in an Illinois-chartered savings and loan association was not a "security" within the meaning of that term in the Securities Exchange Act. Being a case of first impression the court below carefully reviewed the Congressional hearings from 1933 to 1964 regarding securities regulation. There is no doubt that savings accounts in state savings and loan associations were well known by Congress, as evidenced by the hearings preceding the enactment of the Securities Act of 1933 (15 U.S.C. § 77a *et seq.*) and the Securities Exchange Act of 1934 (*App. to Petition*, pp. 26-27). The inescapable conclusion was that there was no intent to include regulation of such savings accounts under the Securities Exchange Act of 1934. Such accounts have the characteristics most closely resembling the short-term debtor-creditor transactions which were specifically excluded from the definition of the term "security" in the 1934 Act (15 U.S.C. § 78 c (a) (10)). Again, in 1963, prior to the enactment by Congress in 1964 of amendments to the Securities Exchange Act of 1934, hearings were held and testimony was offered by both Professor William L. Cary, then Chairman of the Securities and Exchange Commission, and Mr. Milton Cohen, Director of a Special Study of the Securities and Exchange Commission. Both Messrs. Cary and Cohen and the technical statement submitted by the SEC argued that share accounts (as opposed to other categories within savings and loan associations) were not to be covered by such amendments nor were they within the coverage of the 1934 Act (Cf. 15 U.S.C. § 78 l (g) (2) (C)). Mr. Cohen said:

"[I]n many of these organizations the person who has an interest in the association is in the nature of a savings—a savings interest. He doesn't have any-

thing that he can usually transfer, as he can a share of stock, but in more recent years there has been a development in this area whereby stock in these organizations have been created for sale to the public as an investment. It is in this particular area that attention is being given to them within the purview of the securities acts." Hearings on H.R. 6789, H.R. 6793 and S. 1642 before a Subcommittee of the House Committee on Interstate and Foreign Commerce, 88th Cong., 1st Sess., pp. 272-273." (Also see House Hearings, *supra*, at p. 1361.)

The awareness of Congress of the existence of savings accounts in the early years of regulation of the securities field distinguishes such accounts from all sorts of schemes, "many of them of the Alice in Wonderland variety" which are clearly the forms of transactions that were to be regulated. See *S.E.C. v. C. M. Joiner Leasing Corp.*, 320 U.S. 344 (1943) and *S.E.C. v. W. J. Howey Co.*, 328 U.S. 293 (1946) as discussed by the court below.

It was also indicated in the opinion by the Court of Appeals that the most striking analogy to a savings account in City Savings Association (a mutual savings and loan association chartered by the State of Illinois) was to an insurance policy in a mutual insurance company. Since such an insurance policy was not to be considered a "security" within the meaning and intent of the Securities Exchange Act savings accounts were likewise not such "securities".

Therefore the court properly decided that savings accounts were not intended by Congress to come within the ambit of the Securities Exchange Act of 1934 (Cf. Preamble of said Act, 15 U.S.C. § 78 b, *App. herein*, 11 *et seq.*)

II.

**WITHDRAWABLE ACCOUNTS ARE NOT INCLUDED
BY THE TERMS OF THE ACT ITSELF.**

It has been established that Congress did not intend to include withdrawable accounts in savings and loan institutions within the coverage of the anti-fraud provisions of the Securities Exchange Act (15 U.S.C. § 78 j (b)). The definition of a "security" for the purposes of this Act makes it clear that Congress has not done so.

Section 3(a) (10) of the Securities Exchange Act (15 U.S.C. 78c (a)) defines the term "security" as follows:

(10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization, certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

It is to be noted that unlike the instruments included in this definition a withdrawable account has a fixed, rather than a fluctuating, value, is not transferable, is withdrawable in full at any time upon giving reasonable notice and is increased by dividend payments at a fixed rate in the nature of interest, which rate is usually competitive with

other savings and loan associations and banks in the area. The only risk taken is when the association ceases to be a going concern. This occurred in this case, when the state authorities took custody and prevented any further withdrawal of the association's assets to protect all of its depositors. A risk of this nature may result even from the failure of institutions involved in the short-term debtor-creditor transactions specifically not included in the statutory definition of "security".

III.

THERE IS NO IMPORTANT QUESTION OF FEDERAL LAW NOR ANY CONFLICT OF DECISIONS BETWEEN THIS OR ANY OTHER COURT.

Simply stated, the Court of Appeals ruled that a withdrawable account was not a "security" under the Exchange Act. No other question was involved. No *dicta* in the case limits or extends the construction of the definition of the term "security" as it is used in the 1934 Act. The court below, within the confines of the interpretations as set forth in the decisions of this Court relating to the Securities Act of 1933 [*S.E.C. v. C. M. Joiner Leasing Corp.*, 320 U.S. 344 (1943); *S.E.C. v. W. J. Howey Co.*, 328 U.S. 293 (1946); *S.E.C. v. Variable Annuity Life Insurance Co.*, 359 U.S. 65 (1959)] properly interpreted this narrow area of the Securities Exchange Act as determined from the intent of Congress and this Court's opinions. The decision merely follows the long standing notion that withdrawable accounts, like savings accounts, are not covered by the 1934 Act. Such a limited point clearly is not the type of issue that would require the granting of *certiorari*. Petitioners have cited no other case that is in conflict with the holding of the court below.

State savings and loan associations are under strict supervision and control of state agencies. Not being private enterprises, they are regulated as quasi-public institutions. *Hopkins Federal Savings & Loan Ass'n v. Cleary*, 296 U.S. 315, 328-329 (1935). The state has a peculiar interest in the concomitant power of supervision and regulation of savings and loan associations to prevent injury and loss to the members of such associations. Depositors holding savings accounts are manifestly protected by state authority. See also *Variable Annuity*, *supra*, at 68, 74 (concurring opinion), 99-101 (dissenting opinion).

It would create severe hardship on many individual depositors if petitioners would prevail in the instant case since a number of depositors of the City Savings Association would be treated far differently from the petitioners in this case. Petitioners are seeking to receive a far greater return than the many depositors who would not come within the restrictive confines of petitioners' position. Such a result would be contrary to the intended purposes of the Exchange Act. Consequently the state officials are seeking to have all depositors be treated equally rather than to prefer some over others.

CONCLUSION

For the foregoing reasons it is respectfully submitted that this petition for a writ of *certiorari* be denied.

Respectfully submitted,

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APPENDIX

Section 2 of the Securities Exchange Act of 1934 reads as follows (15 U.S.C. § 78b):

"Necessity for regulation

For the reasons hereinafter enumerated, transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, including transactions by officers, directors, and principal security holders, to require appropriate reports, and to impose requirements necessary to make such regulation and control reasonably complete and effective, in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets in such transactions:

(1) Such transactions (a) are carried on in large volume by the public generally and in large part originate outside the States in which the exchanges and over-the-counter markets are located and/or are effected by means of the mails and instrumentalities of interstate commerce; (b) constitute an important part of the current of interstate commerce; (c) involve in large part the securities of issuers engaged in interstate commerce; (d) involve the use of credit directly affect the financing of trade, industry, and transportation in interstate commerce, and directly affect and

influence the volume of interstate commerce; and affect the national credit.

(2) The prices established and offered in such transactions are generally disseminated and quoted throughout the United States and foreign countries and constitute a basis for determining and establishing the prices at which securities are bought and sold, the amount of certain taxes owing to the United States and to the several States by owners, buyers, and sellers of securities, and the value of collateral for bank loans.

(3) Frequently the prices of securities on such exchanges and markets are susceptible to manipulation and control, and the dissemination of such prices gives rise to excessive speculation, resulting in sudden and unreasonable fluctuations in the prices of securities which (a) cause alternately unreasonable expansion and unreasonable contraction of the volume of credit available for trade, transportation, and industry in interstate commerce, (b) hinder the proper appraisal of the value of securities and thus prevent a fair calculation of taxes owing to the United States and to the several States by owners, buyers, and sellers of securities, and (c) prevent the fair valuation of collateral for bank loans and/or obstruct the effective operation of the national banking system and Federal Reserve System.

(4) National emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden interstate commerce and adversely affect the general welfare, and precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations in the prices of securities.

tuations of security prices and by excessive speculation on such exchanges and markets, and to meet such emergencies the Federal Government is put to such great expense as to burden the national credit. June 6, 1934, c. 404, § 2, 48, Stat. 881."

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In the
Supreme Court of the United States

OCTOBER TERM, 1966

ALEXANDER TUHEREPNIN, MING TUHEREPNIN, CHARLES
NOLL, MAYBELLE NOLL, HARRY BLOCK, JEANETTE A.
BLOCK, WERNER D. BLOCK, ADRIAN DA PRATO, PETER
DA PRATO, FREDERICK D. WAHL, ANNE W. WAHL,
THEODORE MACHATKA, MARIE B. MACHATKA, JOSEPH
NOVAK, FRANCES NOVAK, MARYBETH SIMJACK, WALTER
R. ANDERSON and HELEN K. KELLOGG,

Petitioners,

vs.

JOSEPH E. KNIGHT, JUSTIN HULMAN, CITY SAVINGS AS-
SOCIATION, DENNIS KIRBY, HARRY HARTMAN, LOUIS
KWASMAN, ROBERT FRANZ, STANLEY PASKO, JOSEPH
TALARICO, JR., HERBERT J. HOOVER, ROBERT M. KRAM-
ER, C. ORAN MENNIK and GLORIA MENNIK SPRINCK,

Respondents.

BRIEF IN OPPOSITION TO PETITION FOR A WRIT
OF CERTIORARI TO THE UNITED STATES COURT
OF APPEALS FOR THE SEVENTH CIRCUIT.

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**In the
Supreme Court of the United States**

OCTOBER TERM, 1966

No. 1301

**ALEXANDER TCHEREPNIN, MING TCHEREPNIN, CHARLES
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SOCIATION, DENNIS KIRBY, HARRY HARTMAN, LOUIS
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Respondents.

**BRIEF IN OPPOSITION TO PETITION FOR A WRIT
OF CERTIORARI TO THE UNITED STATES COURT
OF APPEALS FOR THE SEVENTH CIRCUIT.**

Statutes Involved

In addition to the statutes and regulations cited in the
Petition, the following statute is also involved:

Securities Exchange Act of 1934, § 2, 48 Stat. 881, 15 U.S.C. §78(b) (1964). The full text of this statute is set forth in the Appendix to this brief.

Statement of the Case.

This case is concerned solely with withdrawable capital accounts of the City Savings Association, a savings and loan association chartered by the State of Illinois. The Illinois Savings and Loan Act authorizes the creation of associations having a capital structure consisting of either withdrawable capital accounts or permanent reserve shares, or both. *Ill. Rev. Stat. Ch. 32, §761 (1965)*. City Savings Association did not issue permanent reserve shares, but only issued withdrawable capital accounts.

Petitioners' statement of the case fails to set forth the characteristics of withdrawable accounts in Illinois Savings and Loan Associations. These characteristics may be summarized as follows:

1. Withdrawable capital accounts may be issued in unlimited amounts. *Ill. Rev. Stat., ch. 32, §728(5) (1965)*. By comparison, permanent reserve shares must have a par value and a limited amount which can be issued. *Ill. Rev. Stat., ch. 32, §728(6) (1965)*.

2. Withdrawable capital accounts are not subject to the securities article of the Uniform Commercial Code. *Ill. Rev. Stat., ch. 32, §768(c) (1965)*.

3. Withdrawable capital accounts are not negotiable and may be transferred only by assignment. *Ill. Rev. Stat., ch. 32, §768(b), (c) (1965)*.

4. Withdrawable capital accounts are subject to forced redemption and retirement at any time upon the call of the Board of Directors. *Ill. Rev. Stat., ch. 32 §775(a) (1965)*.

5. Withdrawable capital accounts are fully matured and completely withdrawable at the time they are issued. *Ill. Rev. Stat.*, ch. 32, §§762(a) and 773(a) (1965). Permanent reserve shares, of course, are not withdrawable. *Ill. Rev. Stat.*, ch. 32, §763(a) (1965).

6. Withdrawable capital accounts have no pre-emptive rights.

7. Withdrawable capital accounts are evidenced by a certificate or account book. *Ill. Rev. Stat.*, ch. 32, §768(a) (1965).

8. Holders of withdrawable capital accounts are not entitled to inspect the general books and records of the association. *Ill. Rev. Stat.*, ch. 32, §748 (1965).

9. Holders of withdrawable capital accounts are entitled to vote for directors, *Ill. Rev. Stat.*, ch. 32, §742 (1965).

10. Withdrawable capital accounts are entitled to dividends as may be declared by the Board of Directors. *Ill. Rev. Stat.*, ch. 32, §762(b) (1965).

11. No annual or other report is furnished to depositors, although an annual report must be published in at least one newspaper. *Ill. Rev. Stat.*, ch. 32, §844(c) (1965).

Petitioners' statement of the case is also inaccurate and misleading in its reference to the withdrawable capital accounts of City Savings Association as "shares" and "capital shares." (Petition 3-4.) The Illinois statutes which provide for the creation of the interests before this Court use the term "withdrawable capital accounts" when referring to these interests. *Ill. Rev. Stat.*, ch. 32, §§761-762, 768-773, 775, 777, 779 (1965).

REASONS FOR DENYING THE WRIT

I.

THE DECISION OF THE COURT OF APPEALS FOR THE SEVENTH CIRCUIT RELATES ONLY TO THE NARROW QUESTION OF THE APPLICABILITY OF THE SECURITIES EXCHANGE ACT OF 1934 TO THE WITHDRAWABLE CAPITAL ACCOUNTS OF CITY SAVINGS ASSOCIATION AND HAS NO SIGNIFICANCE BEYOND THE FACTS OF THIS CASE.

A.

The Decision Below Does Not Limit The Act's Applicability to Other Securities.

The Court below correctly held that the withdrawable capital accounts of City Savings Association were not "securities" within the meaning of that term as used in the Securities Exchange Act of 1934, and accordingly ordered the complaint dismissed. The Court carefully limited its opinion to the facts of this case and to the characteristics of City Savings Association's withdrawable capital accounts as they related to the statutory definition of the term "security."

The Court does not overrule any prior decisions of this or any other court and leaves standing numerous cases holding that instruments encompassed by the specific language of the definition are "securities." Contrary to Petitioners' assertion, (Petition 12-13) the Court did not announce any general rule that such instruments must also meet a further general test of being "commonly known

as securities" to make them subject to the Act.¹ As thus viewed, the lower court's opinion does not in any way limit the applicability of the Securities Exchange Act of 1934 or curtail its enforcement.

B.

The Decision Of The Court Of Appeals Has No Application Beyond the Facts of This Case.

Petitioners have attempted to convince this Court that the decision below has nationwide scope. (Petition 10.) Petitioners theoretically are correct that the decision applies to the holders of similar withdrawable capital accounts in other savings and loan associations. But beyond theory, the actual impact of the decision is negligible and insignificant. That not one account-holder (let alone the "millions" charged by petitioners) has or will be adversely affected by the decision is amply demonstrated by the fact that not one case seeking to apply the 1934 Act to withdrawable capital accounts has arisen in the 33 years since the Act became effective. Outside of the petitioners in this case, no holders of withdrawable capital accounts have sought the protection of the 1934 Act.²

¹ *Llanos v. United States*, 206 F.2d 852 (9th Cir. 1953), which holds that the phrase, "any instrument commonly known as a security" is not a limitation on the applicability of the Act, was not discussed, much less overruled, by the Court below.

² Petitioners cite several lower court cases supposedly holding that withdrawable capital accounts are securities. The case of *SEC v. American International Savings and Loan Association*, 199 F.Supp. 341 (D. Md. 1961) is clearly inapplicable because the court there held that American International was not operating as a savings and loan association, but was operating as a corporation. *United States v. Hopps*, 215 F.Supp. 734 (D. Md. 1962), *aff'd*, 331 F.2d 332 (4th Cir. 1964) does not purport to adjudicate that withdrawable capital accounts are securities and in fact cites *SEC v. American International Savings and Loan Association*, *supra*, as an example of an association which only operates nominally as such.

C.

Application Of The 1934 Act To Withdrawable Capital Accounts Serves No Useful Purpose.

The reason why the question presented has never arisen before is obvious. Application of the 1934 Act to withdrawable capital accounts serves no useful purpose. The state laws which authorize the creation of withdrawable capital accounts also authorize what the name implies—the right of the depositor to withdraw his account at any time. See *Ill. Rev. Stat.*, ch. 32, §§762(a), 773(a) (1965). In other words, the depositor, at any time he so wishes (and without the necessity of a lawsuit) can rescind the transaction and have immediate restitution of his deposit. Under the 1934 Act (assuming *arguendo* that it applies), this can be accomplished only by a lawsuit.

As long as the savings and loan association is a going concern, the state remedy is fully effective and a depositor (whether merely disgruntled or actually defrauded or merely desirous of a return of his money) quite naturally would never resort to the Securities Exchange Act for a remedy. Therefore, application of the 1934 Act to these accounts is unnecessary.

Nor does the fact that the association is in liquidation require application of the 1934 Act to these accounts. Although the right to immediately withdraw the deposit ends when an association goes into liquidation, nevertheless the depositor is still entitled to a return of his deposit under the state laws. See *Ill. Rev. Stat.*, ch. 32, §§907-908 (1965). The 1934 Act does not give a greater remedy or change the result.

Wisconsin Bankers Association v. Robertson, 294 F.2d 714 (D.C. Cir. 1961) merely held that shares in a federal savings and loan association were investments and not exactly equivalent to bank deposits. The court did not determine whether such shares were securities.

Petitioners seek to apply the 1934 Act in this case for the sole purpose of obtaining a priority over other depositors not within their class. But the 1934 Act does not authorize this. The 1934 Act merely allows the depositor to reduce to judgment his concededly valid claim against the association. Nothing in the 1934 Act gives these judgments priority, and therefore the depositors must still share pro rata in the assets of the association.

As a matter of fact, petitioners, in oral argument below, abandoned their contention that they are by virtue of the Securities and Exchange Act of 1934 entitled to a prior claim to the assets and stated that they claimed a priority based on the provisions of the Illinois Savings and Loan Act and an amendment to that Act in 1959.³ But this is a question of local law and not a question under the 1934 Act. Obviously it was the intent of Congress in excluding state savings and loan associations from Federal bankruptcy jurisdiction [11 U.S.C. §22, (1964)], that these questions of priority to assets in the liquidation of state chartered savings and loan associations should be decided by state authorities.

³ Petitioners base their claim to priority on an amendment (repealed in 1965) which became effective on July 9, 1959. [Ill. Rev. Stat., ch. 32, §773(h) (1963)]. This amendment allowed an association which had placed withdrawal restrictions on its accounts to accept new deposits, provided no limitations were placed upon withdrawal of the new accounts. Petitioners, who represent persons who made deposits after this amendment, argue that they are entitled to preference over old depositors.

II.

THE DECISION BELOW CORRECTLY FOUND THAT CONGRESS DID NOT INTEND WITHDRAWABLE CAPITAL ACCOUNTS TO BE SECURITIES UNDER THE 1934 ACT.

In any case involving a question of the application of the Securities Exchange Act of 1934, the central question to be resolved is whether Congress intended the Act to apply. In this Court's previous decisions concerning the definitions of "securities" in the Securities Exchange Act of 1933 placed primary emphasis upon the intent of Congress. *SEC v. C. M. Joiner Leasing Corp.*, 320 U.S. 344, 350-53 (1943); *SEC v. Variable Annuity Life Insurance Co.*, 359 U.S. 65-69 (1959); *SEC v. W. J. Howey Co.*, 328 U.S. 293, 298-99 (1946). That is the sole consideration involved here. As demonstrated below, Congress did not intend withdrawable capital accounts to be securities under the 1934 Act.

A. Congress Specifically Excluded Short-term Fixed Obligations From The Act.

Congress exempted from the definition of the term "security" such interests as currency, notes, drafts, bills of exchange and bankers' acceptances which have a maturity at the time of issuance of not exceeding nine months. Securities Exchange Act of 1934, §3(a)(10), 15 U.S.C. §78(a)(10) (1964) (Appendix to Petition 44.) By this exception, Congress was declaring that fixed-amount obligations fully matured at issue would not be subject to the Act. Withdrawable capital accounts in savings and loan associations are fully withdrawable at any time and are,

therefore, mature at issue. The deposit is a fixed amount obligation and does not fluctuate in value. The Court below relied upon this evidence of Congressional intent. *Tcherepnin v. Knight*, 371 F.2d 374, 377 (7th Cir. 1967) (Appendix to Petition 25).

B. Congress Intended the Act to Apply Only to Interests Having a Fluctuating Market Value.

Congress clearly expressed its intent that the 1934 Act was designed to regulate only securities which are negotiable and for which a fluctuating market exists. As Congress clearly stated, the Act was designed to regulate

"transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets . . . [when] the prices of securities on such exchanges and markets are susceptible to manipulation and control, and the dissemination of such prices gives rise to excessive speculation resulting in sudden and unreasonable fluctuations in the prices of securities . . ." Securities Exchange Act of 1934, §2, 15 U.S.C. §78b (1964). (The full text of Section 2 is set forth in the Appendix to this brief.

This Congressional purpose was clearly recognized by this Court in *SEC v. C. M. Joiner Leasing Co.*, 320 U.S. 344, 351 (1943):

"In the Securities Act, the term 'security' was defined to include by name or description any documents in which there is *common trading for speculation or investment*." (Emphasis added.)

Since a withdrawable account in an Illinois savings and loan association is by statute made non-negotiable, no fluctuating market exists for savings accounts and as a consequence they are not traded either on exchanges or on

over-the-counter markets. (The SEC, in its brief below, admitted that withdrawable capital accounts "are not commonly traded." Brief p. 24) Congress thus did not intend for them to be subject to the 1934 Act. The Court below correctly relied upon this Congressional intent in reaching its decision. *Tcherepnin v. Knight*, 371 F.2d 374, 376, 377 (7th Cir. 1967) (Appendix to Petition 24-25).

Also, the historical context in which the 1934 Act was enacted furnishes further evidence of the intent of Congress to regulate only those interests having a fluctuating value.⁴ As reflected in Section 2 of the Act, the Great Crash of 1929 was attributed by many to excessive speculation in securities with great fluctuation in their prices. This led Congress to enact remedial legislation.

But neither speculation, trading, or fluctuation in prices occurs with respect to withdrawable capital accounts; and thus they fall outside the scope of intended Congressional regulation.

C. Congress and the SEC Consider Withdrawable Accounts as Being Similar to Bank Accounts and Insurance Policies, Which Are Not Securities.

The characteristics of the withdrawable capital account are much like those of a bank deposit. Neither is subject to fluctuation in price and neither is negotiable or traded. Both earn income, expressed as a percent per annum. Of course, there are differences between the bank account and the withdrawable savings account but these differences do not call for application of the 1934 Act to savings accounts.

⁴ As this Court stated in *Great Northern Railway Co. v. United States*, 315 U.S. 262, 273 (1942): "Courts in construing a statute may with propriety recur to the history of the times when it was passed."

The Securities Exchange Commission has always taken the position that withdrawable savings accounts are similar to deposits in banks and, therefore, not subject to the Act. As Chairman Cary testified in hearings for the 1964 amendments to the Securities Act:

"On the other hand, savings accounts in savings and loan associations are not subject to the bill just as insurance policies are not covered. Because of the fact that most savings and loan associations issue so-called shares which in fact merely evidence the existence of a savings account, special provision had to be made in proposed §12(g)(2)(c) of the bill to exempt that type of 'share'." *Hearings on H.R. 6789, H.R. 6793 and S. 1642 before a Subcommittee of the House Committee on Interstate and Foreign Commerce, 88th Cong. 1st Sess., page 1213 (1963).*

As the Commission explained in a memorandum to the House Subcommittee, "the sole purpose of this exemption is to assure that depositors in savings and loan associations and similar institutions are treated exactly as bank depositors and not as shareholders of equity securities for the purpose of the coverage criteria contained in the bills." House Hearings, *supra* at page 1361.

Further, as indicated by the testimony of Chairman Cary, the Securities Exchange Commission also views withdrawable capital accounts in savings and loan associations in the same light as insurance policies, which are clearly not securities under either the 1933 or 1934 Acts. [2 *Loss, Securities Regulation* 497 (2d Ed. 1961)]. Mr. Cary testified that

"With respect to savings and loan associations, an effort is made to treat them in essentially the same manner as insurance companies are treated, that is, mutual savings and loan associations will be exempt, just as mutual insurance companies are." House Hearings, *supra*, page 1213.

Finally, as the court below pointed out, Congress, by excluding the phrase "evidence of indebtedness" from the 1934 Act while at the same time including it within the definition of "security" under the 1933 Act, expressed its intent that instruments which were not specifically mentioned in the definition but which had the characteristics of debt were not to be considered "securities." *Tcherepnin v. Knight*, 371 F.2d 374, 377-78 (7th Cir. 1967) (Appendix to Petition 27.)

Further evidence of Congressional intent to exclude savings and loan associations from federal regulation is their specific exemption from the Bankruptcy Act. See 11 U.S.C. § 22 (1964). As pointed out above, the 1934 Act can only have significance for holders of withdrawable capital accounts in the event of liquidation and insolvency. But the Bankruptcy Act clearly indicates that state law and not the 1934 Act should then be applicable.

III.

THE HOLDING OF THE COURT BELOW IS CONSISTENT WITH PRIOR DECISIONS OF THIS COURT.

This Court has not decided the question of what constitutes a "security" within the meaning of that term as defined in the Securities Exchange Act of 1934. However, it has decided questions under the Securities Act of 1933, which presumably give guidelines for resolving the question presented by this case. In discussing whether assignments of oil leases were securities under the 1933 Act this Court stated: "... In the Securities Act the term 'security' was defined to include by name or description many documents in which there is *common trading for speculation or investment*." *SEC v. C. M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943) (Emphasis ad-

ded.) In *SEC v. W. J. Howey Co.*, 328 U.S. 293, 301 (1946), this Court stated its view of the law in this area even more clearly: "The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."

There are three requirements, therefore, for an instrument to be a security within the 1934 Act: (1) There must be an investment of money in a common enterprise; (2) there must be profits derived solely from the efforts of others; and (3) there must be common trading for speculation or investment. All of these elements are missing from the withdrawable capital accounts of savings and loan associations.

In the first place, a deposit in a withdrawable savings account is not an investment but actually creates a debtor-creditor relationship. *Harn v. Woodard*, 151 Ind. 132, 50 N.E. 33 (1898). The depositor loans his money to the association with the knowledge that it is withdrawable at will and in the expectation that his deposit will earn interest. While the Illinois courts have not definitely adjudicated this relationship, numerous other jurisdictions confirm that the relationship is one of debtor and creditor. See *In re Krueger's Estate*, 180 Wash. 165, 39 P.2d 381, 383 (1934); *Bell v. Bakerstown Savings Assn.*, 385 Pa. 158, 122 A.2d 411, 413 (1956); *Rummens v. Home Savings Assn.*, 182 Wash. 539, 47 P. 2d 845, 846 (1935).⁵ Thus, the rela-

⁵Petitioners contend that the Illinois Legislature has decreed that withdrawable capital accounts are "securities." However, petitioners rely upon an exemption from the provisions of the Illinois Blue Sky Law. Petitioners made this same contention below. The court below correctly held that exemptions from coverage do not constitute evidence of inclusion within the definition, and cited a similar exemption for insurance policies under the 1934 Act, which has been held not to imply that insurance policies are securities in the first instance.

tionship in the instant case is more closely analogous to one of debtor-creditor and *not* one of investment. The Court below correctly found that the "investment in a common enterprise" test of this Court was not met. *Tcherepnin v. Knight*, 371 F.2d 374, 377 (7th Cir. 1967) (Appendix to Petition 26).

In the second place, profit is not derived "solely from the efforts of others." Money that is deposited is loaned to other members of the savings and loan association. Depositors and borrowers must be members of the association. *Ill. Rev. Stat.*, ch. 32, §741 (1965). Thus, the profits of the enterprise result from the activities of members among themselves. Outsiders do not have any but the smallest dealings with the association. The Court below expressly recognized the failure of withdrawable capital accounts to meet this test. *Tcherepnin v. Knight*, 371 U.S. 374, 377 (7th Cir. 1967) (Appendix to Petition 26).

Finally, the *Joiner* case sets up the requirement that there be common trading for speculation or investment for an instrument to be a security. Because of the non-negotiable character and fixed-amount obligation of withdrawable accounts, there is no common trading for speculation or investment in the withdrawable capital accounts of City Savings Association.

This fundamental requirement of trading in interests having a fluctuatory value was recognized in *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959). There, variable annuity contracts, whose return was not fixed but whose return was measured by the success or failure of the investment policy of the annuity company, were held to be securities. As Mr. Justice Brennan emphasized in his concurring opinion, Congress intended to regulate only those interests which had a fluctuating

value and whose return to the investor was measured by the success or failure of the investment company's experience.

Mr. Justice Brennan also pointed out that when it can be found that Congress left substantial responsibility for regulation to the states and that the regulatory functions assigned to the federal government cannot be accomplished by holding the interests involved to be securities, then the Securities Act should not apply. As is the case with insurance companies, the State of Illinois assumes a major role in the regulation of the operation of savings and loan associations.⁶ Given this State regulatory scheme and given Congress's intent to exclude from federal regulation and control interests not having a fluctuating market value, the *Variable Annuity* decision compels the result that these withdrawable capital accounts are not securities within the meaning of the 1934 Act.

⁶For example, in Illinois the investments made by savings and loans are strictly limited by statute. Ill. Rev. Stat., ch. 32, §§791 through 804 (1965). Directors or officers who knowingly make or plan an unauthorized investment are individually liable for all consequential damages to the depositors. Ill. Rev. Stat., ch. 32, §902 (1965). The Commissioner of Savings and Loan Associations is given supervisory power over state chartered savings and loan associations. He is required to cause a surprise examination of every association annually and is empowered to compel compliance with recommended corrective measures. Ill. Rev. Stat., ch. 32, §842 (1965). Under certain circumstances, the Commissioner is empowered to take custody of any association which has refused to take corrective action or which has impaired its withdrawable capital or which is being conducted in a fraudulent, illegal or unsafe manner. Ill. Rev. Stat., ch. 32, §848 (1965). The Commissioner does not relinquish custody until the causes for his taking custody have been removed. Ill. Rev. Stat., ch. 32, §854 (1965).

Of course, petitioners here are bearing the risk of insolvency of the Association. However, as Mr. Justice Brennan pointed out, the Federal Securities Acts are not designed to protect against this risk:

"Even more unpersuasive is the respondents' argument that even in a traditional annuity the policyholder bears the investment risk in the sense that he stands the risk of the company's insolvency. The prevention of insolvency and the maintenance of 'sound' financial condition in terms of fixed-dollar obligations is precisely what traditional state regulation is aimed at." *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65, 90-91 (1959).

And as further pointed out by Mr. Justice Harlan in his dissenting opinion in the *Variable Annuity* case, savings bank deposits were equated by Congress with insurance policies and neither were intended to be subject to the Securities Exchange Act of 1934. (359 U.S. at 98-99.)

CONCLUSION

For the reasons stated above, these Respondents respectfully pray that the petition for a writ of certiorari be denied.

Respectfully submitted,

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APPENDIX

APPENDIX

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APPENDIX

Securities Exchange Act of 1934, §2, 48 Stat. 881, 15 U.S.C. §78(b) (1964):

“For the reasons hereinafter enumerated, transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, including transactions by officers, directors, and principal security holders, to require appropriate reports, and to impose requirements necessary to make such regulation and control reasonably complete and effective, in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets in such transactions:

“(1) Such transactions (a) are carried on in large volume by the public generally and in large part originate outside the States in which the exchanges and over-the-counter markets are located and/or are effected by means of the mails and instrumentalities of interstate commerce; (b) constitute an important part of the current of interstate commerce; (c) involve in large part the securities of issuers engaged in interstate commerce; (d) involve the use of credit, directly affect the financing of trade, industry, and transportation in interstate commerce, and directly affect and influence the volume of interstate commerce; and affect the national credit.

“(2) The prices established and offered in such transactions are generally disseminated and quoted throughout the United States and foreign countries and constitute a basis for determining and establishing the prices at which securities are bought and sold, the

App. 2

amount of certain taxes owing to the United States and to the several States by owners, buyers, and sellers of securities, and the value of collateral for bank loans.

“(3) Frequently the prices of securities on such exchanges and markets are susceptible to manipulation and control, and the dissemination of such prices gives rise to excessive speculation, resulting in sudden and unreasonable fluctuations in the prices of securities which (a) cause alternately unreasonable expansion and unreasonable contraction of the volume of credit available for trade, transportation, and industry in interstate commerce, (b) hinder the proper appraisal of the value of securities and thus prevent a fair calculation of taxes owing to the United States and to the several States by owners, buyers, and sellers of securities, and (c) prevent the fair valuation of collateral for bank loans and/or obstruct the effective operation of the national banking system and Federal Reserve System.

“(4) National emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden interstate commerce and adversely affect the general welfare, are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of security prices and by excessive speculation on such exchanges and markets, and to meet such emergencies the Federal Government is put to such great expense as to burden the national credit.” Securities Exchange Act of 1934, § 2, 15 U.S.C. § 78b (1964).

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In the Supreme Court of the United States

OCTOBER TERM, 1966

No. 1301

ALEXANDER TCHEREPNIN, ET AL., PETITIONERS

v.

JOSEPH E. KNIGHT, ET AL.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED
STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

MEMORANDUM FOR THE SECURITIES AND EXCHANGE COM-
MISSION AS AMICUS CURIAE IN SUPPORT OF THE PETITION
FOR A WRIT OF CERTIORARI

The Securities and Exchange Commission is filing this memorandum *amicus curiae* because it believes that this case presents an important question in the administration of the Securities Exchange Act of 1934 which this Court should review.

STATEMENT

This is an action brought by a group of holders of withdrawable capital shares of respondent City Savings Association. City Savings is a corporation doing business under the Illinois Savings and Loan Act (32 Ill. Rev. Stat. 701-944). Its capital is repre-

sented exclusively by withdrawable capital shares and share accounts.¹ Under Illinois law, every capital account in a savings and loan association must be "evidenced by one or more appropriate certificates; and either such certificates or an account book, or both" are required to be delivered to the shareholder (32 Ill. Rev. Stat. 768(a)). Each holder of one or more withdrawable shares is a member of the association (Section 741(a)(1)), entitled to "the vote of one share for each one hundred dollars of the aggregate withdrawal value of such accounts" or fraction thereof at meetings of the members (Section 742(d)(2)).² The profits of the association are apportioned, at least annually, by the declaration of dividends "on withdrawable shares and share accounts" (Section 778(c)). City Savings is in the process of liquidation, and its assets are in the custody of respondent Joseph E. Knight, Director of Financial Institutions of Illinois (Pet. App. 20).

The complaint alleges that petitioners' capital share accounts are securities within the meaning of Section 3(a)(10) of the Securities Exchange Act of 1934 (15

¹ Although the Illinois statute permits an association's capital to be "represented by withdrawable capital accounts (shares and share accounts) or permanent reserve shares or both * * *" (32 Ill. Rev. Stat. 761(a)), it does not appear that the respondent association has ever issued anything except withdrawable capital shares. Accordingly, we do not refer herein to provisions of the state statute which would apply exclusively to associations offering permanent reserve shares.

² Every borrower from the association, so long as his loan remains unpaid, is also deemed a member (32 Ill. Rev. Stat. 741(a)(2)), although a borrowing member is entitled only to the vote of one share as such (Section 742(d)(4)).

U.S.C. 78c(a)(10)), that petitioners purchased such securities in reliance upon printed solicitations received from City Savings through the mail, and that such solicitations contained false and misleading statements violative of Section 10(b) of the 1934 Act (15 U.S.C. 78j(b)) and of Rule 10b-5 (17 CFR 240.10b-5) promulgated by the Securities and Exchange Commission thereunder. In particular, the complaint alleges that the solicitations represented City Savings to be a financially strong association and its shares to be a desirable investment but failed to disclose, *inter alia*, that the association was controlled by a person previously convicted of mail fraud involving savings and loan associations (R. 9), that the association had been denied federal insurance of its shareholder accounts because of its unsafe financial policies (R. 12), and that the association had been forced to restrict withdrawals by holders of previously purchased shares (R. 13). Petitioners allege that sales of shares in these circumstances were void under Section 29(b) of the 1934 Act (15 U.S.C. 78cc(b)), and they seek rescission (R. 8, 16).

The sole question presented by the petition for certiorari is whether withdrawable capital shares in a savings and loan association are securities within the meaning of the Act. That question was decided in the affirmative by the district court in denying motions to dismiss the complaint (Pet. App. 19-20). Upon an interlocutory appeal, however, the Court of Appeals for the Seventh Circuit (Judge Cummings dissenting) reversed. It held that the complaint should have been dismissed because the withdrawable capital

shares were "not encompassed in the definition of a 'security'" under the Securities Exchange Act of 1934 and that the district court therefore "lacked jurisdiction of this cause" (Pet. 30).

**THE INTEREST OF THE SECURITIES AND EXCHANGE
COMMISSION**

The Securities and Exchange Commission participated as an *amicus curiae* below and supports the petition for certiorari here because of the importance of this case in determining the reach of the federal securities laws administered by the Commission. Millions of Americans have currently invested more than \$100 billion in savings and loan associations.³ It is thus readily apparent that savings and loan associations are a major conduit of capital funds and play a significant role in the nation's capital market. Congress has charged the Commission with responsibility for fostering the integrity of that market under the federal securities laws. The decision of the court of appeals withholds from a large portion of the investing public the protection afforded by the anti-fraud provisions of the 1934 Act (Section 10) and the regulations fashioned by the Commission thereunder (17 CFR 240.10). The decision not only precludes

³ In January, 1967 approximately \$110,131,000,000 of savings capital were invested in 40,921,000 accounts in the 4511 savings and loan associations insured by the Federal Savings and Loan Insurance Corporation, representing about 96% of the resources of all operating savings and loan associations. Federal Home Loan Bank Board, *FSLIC Insured Savings and Loan Associations, Savings and Mortgage Lending Activity—Selected Balance Sheet Items, January 1967*, Table 1 (February, 1967).

private investors in withdrawable shares of savings and loan associations from seeking relief under Section 10b of the Act and Rule 10b-5, but also denies the Commission power to proceed under those provisions for the the protection of such investors,⁴ since it wholly excludes withdrawable capital shares of savings and loan associations from the reach of the Act.⁵

⁴ Such investors have been protected by action of the Commission pursuant to the Securities Act of 1933. See *Securities and Exchange Commission v. First Capital Sav. & Loan Ass'n.*, (D. Md., No. 60 Civ. 12115), and *Securities and Exchange Commission v. American Seal Sav. & Loan Ass'n.*, (D. Md., No. 60 Civ. 12172), where the Commission obtained injunctions by consent based upon complaints which alleged violation of the antifraud provisions of the Securities Act of 1933 in the offer and sale of "Savings Deposit Pass Books"; cf. *Securities and Exchange Commission v. American Int'l Sav. & Loan Ass'n.*, 199 F. Supp. 341 (D. Md., 1961), where an injunction was granted against an organization which, because found not to be qualified for the exemption contained in Section 3(a)(5) of the Securities Act, was held to have failed to register, under Section 5 of the Act, various securities including "preferred stock" evidenced by deposit books rather than certificates, 199 F. Supp. at 346, 351.

The prevention of deceptive and manipulative practices through litigation under Section 10 of the 1934 Act has constituted an important aspect of the Commission's work. See, e.g., *Securities and Exchange Commission v. Texas Gulf Sulphur Co.*, 258 F. Supp. 262 (S.D.N.Y.) (appeal pending); *Securities and Exchange Commission v. Georgia Pacific Corp.*, No. 66 Civ. 1215 S.D.N.Y. (May 23, 1966); *Securities and Exchange Commission*, 32d Annual Report (1966), pp. 114-116. Section 10b has also become an increasingly effective tool in the hands of private litigants. See *Vine v. Beneficial Finance Co.*, CCH Fed. Sec. Rep. ¶91,906 (C.A. 2); *Hooper v. Mountain States Securities Corp.*, 282 F. 2d 195 (C.A. 5).

⁵ We recognize that the decision of the court of appeals may not affect the applicability to savings and loans shares of the antifraud provisions contained in Sections 12(2) and 17 of the Securities Act of 1933 (15 U.S.C. 77f(2) and 77g). Nevertheless, for a number of reasons, those provisions may be appre-

Furthermore, the significance of the decision below is not limited to the antifraud provisions of the 1934 Act. In holding that capital share accounts are not securities under the Act, the court of appeals necessarily exempted brokers and dealers in such shares from the registration requirements of Section 15 (15 U.S.C. 77f) which expressly provides for liability of persons selling securities on the basis of misleading statements, has a specific requirement of privity, provides no relief where a fraudulent sale is accomplished without any disclosure whatsoever and is subject to a very short statute of limitations. See Section 13 (15 U.S.C. 77m). While certain of these restrictions are not applicable to Section 17(a) of the 1933 Act, it is by no means clear that a private cause of action can be maintained under Section 17. See *Ellis v. Carter*, 291 F. 2d 270, 273-274 (C.A. 9), *Dauphin Corp. v. Redwall Corp.*, 201 F. Supp. 466, 468-469 (D. Del.); 3 Loss, *Securities Regulation* 1781-1787 (2d ed. 1961). But cf. *Osborne v. Mallory*, 86 F. Supp. 869, 878-879 (S.D. N.Y.); *Fischman v. Raytheon Mfg. Co.*, 188 F. 2d 783, 787 n. 2 (C.A. 2). Furthermore Section 10(b) of the 1934 Act and Rule 10b-5 apply to fraud "in connection with" securities transactions, as distinguished from fraud "in" securities transactions, and these provisions are applicable not only to fraud by sellers but also to fraud by purchasers of securities. Fraud in the purchase of savings and loan share accounts could occur whenever there may be uncertainty as to the time or amount of payment, as when an association is in liquidation. (As noted, page 9, *infra*, such shares have been traded on a securities exchange.) Finally, the 1933 Act does not authorize the Commission to adopt rules and regulations, whereas the rule making power under Section 10 of the 1934 Act has enabled the Commission to elaborate upon the broad statutory prohibitions in the light of practical experience in combatting a wide variety of manipulative and deceptive devices. Such rules have, we believe, significantly enhanced the effectiveness of the antifraud provisions of the 1934 Act.

U.S.C. 78o). A number of firms registered with the Commission under the Act as brokers and dealers handle only savings and loan share accounts; other firms deal in these interests as well as in other types of securities. Under the decision of the court of appeals, the former would not be required to register at all and would not be subject to Commission rules relating to their financial responsibility⁶ and to the manner of their dealing with investors;⁷ regulation of the latter would not extend to their activities with respect to savings and loan accounts.

Finally, quite apart from its bearing on savings and loan shares, the highly restrictive reading given the statutory definition of the term "security" presents a broad threat to the Commission's efforts to deal with novel types of financial instruments as they appear. Thus the court concluded that only an instrument "commonly known as a security" can fall within the statutory definition (Pet. App. 24). That approach rejects the more flexible analysis of economic realities which the Commission believes must be employed if the Commission is to serve effectively the remedial purposes intended by Congress. See *Securities and Exchange Commission v. Capital Gains Bureau, Inc.*, 375 U.S. 180, 195; *Securities and Exchange*

⁶ Rule 15c3-1, 17 CFR 240.15c3-1.

⁷ See, e.g., Rule 15c1-4, 17 CFR 240.15c1-4, which requires that the customer in over-the-counter transactions be advised in writing whether the firm has dealt with him as a broker or a dealer, and in the former event the source and amount of any commission. Some savings and loan associations pay commissions for successful solicitation by brokers.

Commission v. W. J. Howey Co., 328 U.S. 293, 298, 301.

DISCUSSION

The question which petitioners present is whether the protections of the Securities Exchange Act of 1934 are available to the holders of some forty million share accounts who have entrusted billions of dollars to the persons who manage savings and loan associations. We believe that the question is important, that it was wrongly decided by the court of appeals, and that it merits review by this Court.

1. "Security" is defined in both the Securities Act of 1933 and the Securities Exchange Act of 1934 to mean, *inter alia*, "stock" and "transferable share."^{*} The legislative history of the Securities Act shows that withdrawable shares issued by savings and loan associations were unquestionably considered to be securities within this definition by the members of Congress most intimately involved in the passage of that Act and the Securities Exchange Act⁹ and who found it appropriate to exempt such shares from registration under the Securities Act (Section 3(a)(5),

^{*} Section 2(1) of the Securities Act, 15 U.S.C. 77b(1); Section 3(a)(10) of the Securities Exchange Act, 15 U.S.C. 78c(a)(10).

⁹ See Hearings on H.R. 4314 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 1st Sess. 70-80 *passim*; Hearings on S. 875 before the Senate Committee on Banking and Currency, 73d Cong., 1st Sess. 50-54, 99-101, 110-113 *passim* (1933).

15 U.S.C. 77c(a)(5)) while leaving them subject to its antifraud provisions (Sections 12(2), 17 (a) and (c), 15 U.S.C. 77l(2), 77q (a) and (c)).¹⁰ There is no suggestion in the legislative history of the Securities Exchange Act that withdrawable shares were not intended to be included within the broad definition of security contained therein. Indeed, within a few months after passage of the 1934 Act the newly-created Securities and Exchange Commission temporarily exempted "passbooks of * * * savings and loan companies" which were then "being traded on the Cleveland Stock Exchange" from the provisions of Sections 7, 8, 12, and 13 of that Act. See Securities and Exchange Commission Release No. 26, October 22, 1934. The limited exemption granted by the Commission, as authorized by Section 3(a)(12), 15 U.S.C. 78c(a)(12), bespeaks the Commission's understanding that such passbooks were securities within the meaning of the Act. That understanding, dating from the earliest days of the Commission's work and virtually contemporaneous with the passage of the Act, is entitled to particular weight. See *Norwegian Nitrogen Products Co. v. United States*, 228 U.S. 294, 315.

¹⁰ Industry representatives welcomed application of the anti-fraud provisions while seeking the exemption from registration, see House Hearings, *supra* n. 9, at 70-80 (testimony of Mr. Morton Bodfish, Executive Manager, United States Building and Loan League); Senate Hearings, *supra*, n. 9, at 50-54 (testimony of Mr. C. Clinton James, Chairman, Federal Legislative Committee of the United States Building and Loan League).

Perhaps because savings and loan associations are subject to state regulatory supervision, over the years the Commission has rarely found occasion to seek to enjoin violations of the federal securities laws by such associations and this accounts for the paucity of case law. But in 1964 Congress clearly recognized that withdrawable shares are securities as defined in the Securities Exchange Act and granted withdrawable shares an exemption from the expanded registration requirements, applicable only to equity securities, adopted by amendment that year. See Section 12(g)(2)(C), 15 U.S.C. 78l(g)(2)(C).¹¹

Moreover, a variety of misleading practices have been recognized as accompaniments of an intensification of competition among financial institutions during the last few years. Thus on December 16, 1966, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Home Loan Bank

¹¹ If it were not apparent from the language of the exemption, the legislative history makes clear that the equity securities granted exemption are withdrawable share accounts. See, e.g., S. Rep. No. 379, 88th Cong., 1st Sess. 61 (1963). The Commission recognized the need for an explicit exemption if withdrawable share accounts were to be relieved from registration. See Technical Statement of the Securities and Exchange Commission, Hearings on H.R. 6789, H.R. 6793 and S. 1642 before a Subcommittee of the House Committee on Interstate and Foreign Commerce, 88th Cong., 1st Sess. 211, 215 (1963); Memorandum of the Securities and Exchange Commission, *id.* at 1360, 1361. See also Letter from Mr. Glen Troop, Staff Vice-President, United States Savings and Loan League to Senator Harrison A. Williams, Jr., June 12, 1963, Hearings on S. 1642 before a Subcommittee of the Senate Committee on Banking and Currency, 85th Cong., 1st Sess. 256-257 (1963).

Board, and the Board of Governors of the Federal Reserve System found it appropriate to point out to their respective constituencies that "[i]n recent years, competition among financial institutions for funds has become intense. An outgrowth of such competition has been the development and use by a few institutions of advertising practices that could be detrimental to the public's attitude toward the nation's financial system. In some respects, certain of the advertising practices are considered misleading." These agencies then outlined certain minimum standards of disclosure to be observed by financial institutions and called attention to the Commission's opinion "that deposit and share accounts are subject to the anti-fraud provisions of the Securities Act of 1933 and the Securities and Exchange Act of 1934 and that advertisements by financial institutions that are contrary to such principles may violate those anti-fraud provisions." See New York Times, December 19, 1966, p. 1, col. 1, p. 22, cols. 4-5.

2. So far as we are aware, the decision below stands alone in holding, under any of the federal securities laws, that a security is not involved where, both in form and in substance, the use or management of other people's money has been solicited and obtained upon a promise of income to be derived from the management of investments pooled in a common enterprise. In this regard it is significant to observe that the opinion of the majority below cites no direct authority in support of its holding.

In reaching its conclusion, the court of appeals departed from the principles enunciated in *Securities and Exchange Commission v. C. M. Joiner Leasing Corp.*, 320 U.S. 344, where this Court rejected the contention that it should "constrict the more general terms [of the definition of 'security' contained in the Securities Act] substantially to the specific terms which they follow" (320 U.S. at 350). The Court held instead that it could not

* * * read out of the statute these general descriptive designations merely because more specific ones have been used to reach some kinds of documents. Instruments may be included within any of these definitions, as matter of law, if on their face they answer to the name or description. [320 U.S. at 351.]

The court below held that the "type of interest now before us, if it is covered by [the statutory] definition, must be 'an instrument commonly known as a security'" (Pet. 24). It thus constricted the specific as well as the general terms of the broad definition attempted by Congress to the narrow scope of a single phrase.¹²

The court of appeals failed to recognize that the statutory definition "embodies a flexible rather than

¹² In contrast, the Court of Appeals for the Ninth Circuit, in *Llanos v. United States*, 206 F. 2d 852, 854, certiorari denied, 346 U.S. 923, expressly rejected the contention that the phrase "any interest or instrument commonly known as a 'security'" limits those which come before" in the definition of security contained in the Securities Act.

a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profit." *Securities and Exchange Commission v. W. J. Howey Co.*, 328 U.S. 293, 299. Had it done so, it would have recognized that a savings and loan share "answer[s] to the name or description" of "transferable share" or "stock"; that the certificate or account book which is required to be delivered to the shareholder (32 Ill. Rev. Stat. 768(a)) is a "certificate of interest or participation in any profit-sharing agreement"; and that the contract entered into between the association and each investor is an "investment contract" as this Court construed that term in *Howey*—all of which are defined to be securities under both the Securities Act and the Securities Exchange Act.

The shareholders of a savings and loan association, like the investors in *Securities and Exchange Commission v. W. J. Howey Co.*, 328 U.S. 293, "provide the capital and share in the earnings and profits; the promoters manage, control and operate the enterprise. It follows that the arrangements whereby the investors' interests are made manifest involve investment contracts, regardless of the legal terminology in which such contracts are clothed." 328 U.S. at 300. Indeed, the shareholders of the respondent savings and loan association have provided all of its capital. (32 Ill. Rev. Stat. 761(a)), are the only persons en-

titled to share in its profits' (Sections 762, 778), and may have surrendered even residual control of their common investment by execution of irrevocable proxies to management (see Pet. 24).

The court of appeals relied heavily on the fact that the phrase "evidence of indebtedness," appearing in the 1933 Act's definition of a security, was omitted from the definition in the 1934 Act. Whatever significance, if any, that omission may have, it clearly cannot signify, as the court supposed, that instruments creating a debtor-creditor relationship are not within the coverage of the Act, since "security" is defined to include "note," "bond" and "debenture," excluding only short term commercial paper. But even if the court were correct in supposing that evidences of indebtedness do not qualify as securities under the 1934 Act, that supposition is irrelevant here since there is no basis whatever for regarding petitioners as creditors when they have no claim for interest on their accounts but participate in the profits of the enterprise. On the contrary, it is precisely to be given the status of creditors that petitioners press this suit (R. 16).

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

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MAY 1967.

MAY 31 1967

Supreme Court of the United States

JOHN F. DAVIS, CLERK

OCTOBER TERM, 1966

No. 4304

104

ALEXANDER TCHEREPNIN, MING TCHEREPNIN,
CHARLES NOLL, MAYBELLE NOLL, HARRY BLOCK,
JEANETTE A. BLOCK, WERNER D. BLOCK, ADRIAN
DA PRATO, PETER DA PRATO, FREDERICK D. WAHL,
ANNE W. WAHL, THEODORE MACHATKA, MARIE B.
MACHATKA, JOSEPH NOVAK, FRANCES NOVAK, MARY-
BETH SIMJACK WALTER R. ANDERSON AND HELEN
K. KELLOGG,

Petitioners,

vs.

JOSEPH E. KNIGHT, JUSTIN HULMAN, CITY SAVINGS
ASSOCIATION, DENNIS KIRBY, HARRY HARTMAN,
LOUIS KWASMAN, ROBERT FRANZ, STANLEY PASKO,
JOSEPH TALARICO, JR., HERBERT J. HOOVER, ROBERT
M. KRAMER, C. ORAN MENSIK AND GLORIA MENSIK
SPRINCZ,

Respondents.

REPLY TO BRIEFS IN OPPOSITION TO PETITION
FOR WRIT OF CERTIORARI.

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IN THE
Supreme Court of the United States

OCTOBER TERM, 1966.

No. 1301.

ALEXANDER TCHEREPNIN, MING TCHEREPNIN,
CHARLES NOLL, MAYBELLE NOLL, HARRY BLOCK,
JEANETTE A. BLOCK, WERNER D. BLOCK, ADRIAN
DA PRATO, PETER DA PRATO, FREDERICK D. WAHL,
ANNE W. WAHL, THEODORE MACHATKA, MARIE B.
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Respondents.

**REPLY TO BRIEFS IN OPPOSITION TO PETITION
FOR WRIT OF CERTIORARI.**

The two Briefs filed by respondents may not require a
reply as to the issues before this Court on consideration of
a Petition seeking Certiorari. No objections of any real
substance are raised by them. But interwoven from cover
to cover into arguments mostly irrelevant at this stage

are inaccuracies as to facts, statutes, and case law affecting the validity of every contention.

At this point it is impractical because of time and space factors to correct every departure from fact and law. A series of examples may suffice to place respondents' Briefs in proper perspective. Let us consider the following:

1. The Jenner Brief (p. 7, line 10) asserts:

"As a matter of fact, petitioners, in oral argument below *abandoned* their contention that they are by virtue of the Securities and Exchange Act of 1934 entitled to a prior claim to the assets * * *." (Emphasis supplied.)

The transparency of that assertion is evident, for a summary dismissal would inevitably have ensued, had that been true. That any lawyer in a Securities Act case would abandon the sole ground for federal jurisdiction is incredible. The assertion, of course, is without substance.

2. The Jenner Brief (p. 3) charges that petitioners' Statement of the Case is "inaccurate and misleading in its reference to * * * 'shares' and 'capital shares,'" asserting that the Illinois Act uses "the term 'withdrawable capital accounts' *when* referring to these interests." (Emphasis added.) In support are cited 11 selected sections of the Illinois Savings and Loan Act¹, beginning with § 761; but § 761 supplies a terse rebuttal, for it identifies these interests as "shares and share accounts," viz.:

"(a) The *capital* of an association may be represented by withdrawable capital accounts (*shares* and *share accounts*) * * *.

"(b) All *shares* and capital accounts shall be personal property * * *." (Emphasis added.)

In the context of respondents' charge, the word "when" means "whenever". Thus, it is their claim that whenever

1. Ill. Rev. Stat. c. 32, §§ 701-944 (1965). That Act is sometimes hereinafter referred to as "the Illinois Act". References to section numbers relate to sections of that Act.

the statute refers to such interests, "withdrawable capital accounts" is the only term used; and that the word "share" does not appear in the Act. That is simply untrue.

Almost 50 sections of that Act, not just 11, make specific reference to the interests now before this Court, by a variety of terms. "Share" appears 29 times², which is more often than the 24 times "withdrawable capital accounts" is used specifically. In addition, the Act uses "matured shares"³ "shareholders"⁴ "share interests"⁵ "share accounts"⁶ "withdrawable shares"⁷ and "withdrawable share accounts".⁸ In one context or another the word "share" is used 51 times to refer to this type of capital investment. If indirect references are added, "shares" is still the favorite expression of the legislature in that Act, in discussing such capital interests. Considering that the term "withdrawable capital" (as distinguished from "withdrawable capital account") is also used 42 times,⁹ and "account", "Capital" and "capital accounts", on other occasions,¹⁰ the total usage of terms other than "withdrawable capital accounts" exceeds 100, demonstrating the extent of respondents' oversight.

2. §§ 704(a), 742(d)(2), 742(d)(5), 743, 761(a), 761(b), 774(a), 774(b), 775(b), 794(b), 814(b), 841-3, 853, 875(b).

3. §§ 773(b)(3), 773(b)(4).

4. §§ 875(b), 909(c).

5. § 875(b).

6. §§ 710(t), 741(1), 743, 761(a), 773(g), 778(c), 780(c).

7. §§ 728(a)(5), 741(1), 778(c).

8. §§ 742(d)(2), 780(b)(2), 780(b)(3).

9. §§ 706(b), 706(h), 707(a), 710(i), 710(j), 710(k), 721, 724(c), 729(b)(4), 729(b)(5), 742(a), 743, 762, 773(a), 773(c), 773(d), 773(f), 774(a), 778(d), 780(b)(3), 780(b)(4), 780(d), 792.1, 792.7, 801, 822(a)(2), 848(b), 850(b), 850(c), 853, 877(a), 877(b), 903(d), 908.

10. 710(b), 726(f), 748(a), 768(a), 775(b), 780(b), 853, 748(a), 780(a), 780(b), 814(e), 710(s), 710(t), 743, 761(b), 768(a), 768(d), 773(b)(2), 774(b).

3. Respondents' aversion to the word "share" is understandable. "Transferable share" is one of the specific categories enumerated in the definition of "security" in the Securities Exchange Act of 1934¹¹ (hereinafter "the 1934 Act.").

Being confronted at the outset with the term "share" in both the 1934 Act's definition on which this case turns and throughout the Illinois Act, respondents attempt to escape this embarrassment by their suggestion, as above (Jenner Br. 3), that the word "share" does not even appear in the Illinois Act. But in using "withdrawable capital accounts" instead of "shares" 34 times (15 times at pages 2 and 3 alone) the draftsman is apparently forgetful that "shares and share accounts" is read into the text by reference each time, by mandate of Sec. 761 of that Act.

4. Next, at least 21 times that Brief substitutes for "share" and "shareholder", the terms "deposit", "depositor", "deposited" or "savings account", none of these being found in the Illinois Act. The Clark Brief for certain respondents substitutes "savings accounts" and "depositors" 15 times in its six page Argument. Thus they posit their own vocabulary of terms more to their liking, carrying frames of reference opposite to that intended by the Illinois legislature.

5. The Jenner Brief uses the word "withdrawable" at least 40 times and the above cited non-statutory terms 21 times within its 16 pages to promote the concept that shares representing the capital of a savings and loan association are (1) not shares at all and not capital, but are something else, and (2) are like bank savings accounts and therefore are creditor-debtor deposits, withdrawable at will at any time, none of which is of course true. That Brief does not even attempt to rebut the specification of characteristics and attributes of savings and loan shares and interests

11. § 3(a)(10), 15 U. S. C. § 78c(a)(10).

(Pet. 4 and footnote #5) urged by petitioners as the essential ones which bring capital shares and interests within the precedents cited in the Petition. That such essential characteristics of shares of an Illinois Association are typical of such capital interests in Associations nationwide has been established by petitioners' exhaustive analysis of federal laws and of the laws of each of the fifty states and of the District of Columbia (See Pet. 5).

6. Instead, that Brief supplies its own list of characteristics in 11 numbered paragraphs (pp. 2-3), charging that petitioners' Statement of the case "fails to set forth the characteristics" of the interests involved here (p. 3). A long list of irrelevancies are claimed to be omitted. Even were the "facts" listed there entirely true which they are not, for reasons hereinafter noted, they have no significance.

7. Points 9 and 10 (p. 3) are to be found in petitioners' list (Pet. 5) from which no essential characteristic was omitted. Nos. 9 and 10 concern the rights to vote for directors and to receive dividends if and only if and when, declared by the directors. The right to receive dividends must of course be distinguished from the right to "interest" on bank savings account deposits, contrary to respondents' Briefs (Jenner 13, Clark 6) and contrary to the majority opinion below (App. 26).¹² The right to "interest" on bank savings accounts is fixed and absolute, while the right to receive dividends is not.

8. The Jenner Brief (pp. 2-3) purports to rely on the Illinois Act. The word "depositors" used in point 11 (p. 3) as well as "depositor", "deposit" and "deposited" repeated over and over throughout that Brief, as stated above, do not appear in the Illinois Act but have been borrowed by respondents from the banking industry. Although that Brief says (p. 13) that "the Illinois courts have not definitely adjudicated this relationship"—as to whether

12. App. refers to the Appendix to the Petition for Certiorari.

the owners of capital interests in Illinois associations are creditors of the associations, the Illinois Supreme Court in *Gorham v. Hodge*, 126 N. E. 2d 626, 631, 6 Ill. 2d 31, 41 (1958) has done exactly that, settling the Illinois law. The Court held that an Illinois savings and loan association cannot accept "deposits", for that would create a debtor-creditor relationship with investors which an Illinois association is barred from doing. Accordingly, the majority holding of the lower Court that these capital interests are loans (App. 26) and its repeated use of the terms "deposit" and "depositor" (App. 21) are erroneous, as are the recurring assertions by respondents that these shares constitute a debtor-creditor relationship (Jenner 13), are like a "bank deposit" (p. 10) and have the characteristics of debt (p. 12). "Deposit", "depositor", "deposited" and "savings account" are thus improper usages. The Clark Brief likewise argues "creditor-debtor relationship" by ignoring the law and gratuitously asserting that these interests are "more commonly known as savings accounts" (pp. 3, 4). At page 3 it states that the lower Court followed the "notion" that the 1934 Act does not apply.

9. In the paragraph where the Jenner Brief argues (p. 13) that these interests are loans at interest and that the Illinois courts have not definitely adjudicated the relationship (ignoring *Gorham v. Hodge*), after citing an 1898 Indiana case it is stated that "numerous other" jurisdictions have held that it is a debtor-creditor relationship. It then cites two cases from the State of Washington (1934 and 1936), one from Pennsylvania, and no others. "Numerous other" jurisdictions have not so held, and any of those elsewhere are related to special situations, making them inapposite here.

Further, consistency not being one of its virtues, the Brief in the footnote at page 6 argues that the *Wisconsin Banker's* case held that shares in a federal association were

"investments" and not equivalent to bank deposits. Then after citing (p. 13) non-Illinois cases as controlling in Illinois, it argues that in the instant case the relationship is *not* one of "investment" (p. 14). Even more strange are the qualifying words used at page 6 to indicate that the Court in *Wisconsin Bankers* held that the shares were "not exactly" equivalent to bank deposits. In truth, the Court there held that they are very different. Similarly, at page 13, the brief says the Illinois courts have not "definitely" adjudicated the question of debtor-creditor as to such associations, while in truth, the Illinois Supreme Court *has* "definitely" adjudicated the matter in *Gorham v. Hodge*, as cited by petitioners in their Brief in the lower Court.

Further the statement in the footnote at page 5 that the court in the *American International* case drew a distinction between operating as a "savings and loan association" and "as a corporation" is not borne out by the decision. Operating "as a corporation" is required of such associations in many states including Illinois, and is a sensible way to operate even where not required.

10. Still endeavoring to establish debtor-creditor status for the interests here, which is the thrust of both Briefs, the Jenner Brief, point 5 (p. 3) sets out the always fully withdrawable argument, in keeping with the majority opinion below asserting that such interests are "fully withdrawable when issued". (App. 24.)¹³ The Jenner Brief also argues that the right to withdraw at any time is equivalent to a right to rescind, without a law suit (p. 6). But in fact, the right to withdraw is a qualified one. The laws of virtually all fifty states, the District of Columbia, and of the

13. In making this argument, respondents ignore the fact that the amended complaint charges that petitioners' shares were *not* withdrawable at will (an allegation not disputed in the pleading by them). Further, respondents' debtor-creditor argument is irrelevant as pointed out in the S. E. C.'s *Amicus Curiae* Brief, pp. 10, 11, 14.

federal government permit, and in some states require, the directors of such associations to unilaterally impose restrictions on withdrawals if adequate funds are not available to meet all mortgage commitments and other cash requirements. As occurred with City Savings from 1957 to 1964, such restrictions can continue for years.

This is entirely unlike the situation of banks. If a bank cannot meet withdrawal demands of its depositor-creditors, subject to short notice requirements in such situations, the bank is considered insolvent and is closed, reorganized or taken over by another bank. Federal insurance is paid promptly.

That is not so as to savings and loan associations. If they go on a restricted payout basis, they are not considered insolvent unless the value of their assets shrinks below the total of creditors claims plus the total of so-called "withdrawable" capital. No federal insurance is payable until after a default occurs, meaning "insolvency".

11. The fact that a 1959 Illinois statute¹⁴ (repealed in 1965) prohibited restrictions on withdrawability of new accounts accepted while an Association was on a restricted payout basis as to prior shareholders does not change the actual facts as they happened in this case: Such capital shareholders were simply unable to withdraw their investments in City Savings, on demand, because the Association was continuously in trouble financially due to inadequate cash throughout the years 1957 to 1964, and during that period it imposed restrictions on withdrawals as to all shareholders, new and old.

12. The confusion resulting from respondents' argument below that petitioners' capital interests were actually withdrawable at will at any time under that 1959 amendment, is manifest. The Court below was led into so holding (App. 21, 24, 26). Aside from the factual inability of in-

14. Ill Rev. Stat. C. 32, Sec. 773(h) (1963).

vestors to withdraw at will from City Savings or any association which remains open but unable or unwilling to pay on demand; the 1959 Illinois amendment was as unconstitutional as the 1953 amendment held invalid in *Gorham v. Hodge*. The acceptance of capital accounts, particularly under respondents' interpretation, would have created a "demand account". This would have engaged such associations in the banking business, an activity prohibited to them by Article XI, Sec. 5 of the Illinois Constitution. This prohibition is reflected in Sec. 709(a) of the Illinois Act which provides, "No association to which this Act shall apply shall accept or carry any demand * * * account."

13. The effort of respondents to transmute the status of these investors stands in isolation, against a background of laws similar to those in Illinois in almost all jurisdictions. Such laws provide no comfort to respondents. The legislatures in all states and the Congress have carefully constructed a form of business enterprise where the debtor-creditor relationship would not exist between an association and the investors in its capital. Such capital investments generally are designedly called "shares", "capital accounts", and by other terms of recognized meaning which cannot be confused with banking usage.

To understand the reason for this structuring of the entire industry, it is necessary to compare the long-term mortgage lending function of savings and loan associations with the commercial banking functions of banks, historically and at present. Because banks are subject to demand withdrawals by depositors, and have a debtor-creditor relationship with them, by necessity they have avoided freezing any substantial part of their deposits into long-term real estate mortgage loans. On December 31, 1965, of the total of almost \$378.9 billion of assets of commercial banks in the United States, only 13.1% was invested in such loans.¹⁵

15. Rep. of Call 74, Dec. 31, 1965, FDIC, Washington, D. C. p. 2.

Savings and loan associations on the other hand were created and have multiplied to fill the gap thus left in the national economy. They accumulate capital by selling their shares across the country, and gather together the invested monies of their shareholders for the express purpose of providing funds to satisfy the need for long-term real estate mortgage loans, in their own jurisdictions and in other states. The investments are designated as shares of capital, under one term or another, because that is characteristic of the relationship desired and created by the investment contract. In virtually every jurisdiction, the investment is subject to withdrawal from time to time, if, and only if, the associations have funds available in excess of their currently owing cash commitments for the purpose for which they were founded. On December 31, 1965, of the total of almost \$129.5 billion of assets of savings and loan associations in the United States, 85% was invested in such mortgages.¹⁶

14. The statement in the Jenner Brief (pp. 9, 10) that such interests are not traded either on exchanges or on over the counter markets, and the similar holding of the lower court (App. 28) ignore the holdings of *Fratt v. Robinson* (9 Cir. 1953), 203 F. 2d 627, 630, 631; *Kardon v. National Gypsum Co.* (D. C. E. D. Pa. 1946), 69 F. Supp. 512 (Pet. 9), that such trading is unnecessary. In any event the Jenner statement is simply unsupportable. They are based on assumptions, contrary to general experience. It is not necessary that there be daily trading or frequent trades at all times for securities to be commonly traded. At page 10 that Brief refers to the historical context of the 1934 Act, citing the Great Depression. By 1933 a great many of the substantial associations in most of the large commercial centers of the country had restrictions

16. An. Rep. Dec. 31, 1965, Fed. Home Loan Bank Board, Washington, D. C., p. 133.

in force on withdrawals. Some associations failed and were liquidated; others continued for years on a restricted withdrawal basis. Those investors who required the use of their funds invested in so-called "withdrawable" but actually nonwithdrawable capital shares sold their investments as best they could. Naturally, the amounts realized from such trading fluctuated widely, depending in part upon the reputation of management, its skill in the original investment of funds and the activities of price manipulators. A reputation for loose lending policies would not enhance the market price of shares.

15. The Clark Brief (p. 6) asserts blandly that such interests are *not* transferable. That the Illinois Act (§ 768 (b)) expressly provides that such interests may be transferred by the holder, did not deter respondents in their Briefs in the lower Court, and respondent Clark here, from stating the contrary. Such interests are transferable in all jurisdictions, even where the statutes make no specific provision. An innate attribute of property is the right of the owner to dispose of it, unless restricted by the terms of the grant to him, by law or by contract.

16. That the interests presently before this Court are traded over the counter is apparent from the plight of the 14,000 investors in City Savings Association. Some of those in serious financial straits or having other motives do sell their shares, as is evident to anyone with whom shareholders communicate in this matter. The same was necessarily true even before the association was in liquidation during the seven year period of restrictions on withdrawals. This kind of selling is nothing new, for in 1934 the Securities and Exchange Commission granted a temporary exemption from the 1934 Act as to such interests traded on the Cleveland Stock Exchanges. (S. E. C. Release No. 26.) Industry leaders report that there was heavy trading in such interests in large commercial centers.

17. The Jenner Brief at page 4 asserts, as to the majority opinion below, that:

"The Court carefully limited its opinion to the facts of this case," and "to the characteristics of City Savings Association's 'withdrawable capital accounts' as they related to the statutory definition of the term 'security'".

This is raised in rebuttal to petitioners' assertion that the majority opinion below rejected consideration of all categories of the definition of "security" in the 1934 Act (App. 23) other than "an instrument commonly known as a security;" (App. 24) and that this holding of the Court below necessarily would apply in all cases of interpretation of that definition, involving any security.

The Court did not, by direct caveat or otherwise, "carefully limit its opinion to the facts of this case," as is sometimes done. On the contrary, it speaks of the "*type of interest* now before us," (App. 24) thus making its opinion applicable to associations everywhere in this nation. Further, "type of interest" could and probably would be construed to cover every investment interest having some or all of the characteristics which the Court held are not within the ordinary concept of a security, and which are referred to by the Court in other paragraphs of its opinion. (App. 24-25.) That opinion and respondents say in unison that withdrawable savings and loan capital shares have characteristics unlike those in the "ordinary concept of a security", again making that concept controlling.

18. In addition, the Court's attention is directed to *Archer et al, v. S. E. C.*, 133 F. 2d 795 (8 Cir. 1943), involving certain certificates issued by Pacific States Savings and Loan Association. Those certificates represented

interests in withdrawable capital.¹⁷ At page 801 the decision discloses that these certificates were involved in misconduct by brokers in violation of § 15(c)(1) of the 1934 Act and a rule promulgated pursuant thereto. The decision indicates that the certificates were traded over the counter, that the price fluctuated widely, was manipulated, and that the improprieties constituted a violation of a section of the 1934 Act involving a "security". Further, in the face of the above, it is clear that the decision below puts the 7th Circuit in conflict with the 8th Circuit and its decision in *Archer*, a ground for certiorari which was not known to these petitioners until the *Archer* case was called to their attention on May 25, 1967.

17. The decision does not set forth this fact; but on May 29, 1967, counsel for petitioners ascertained from the Department of Investments, Division of Savings and Loans of the State of California, at San Francisco, California (Messrs. R. McAllister and John Ruster) that the certificates of Pacific States Savings and Loan Association were of the withdrawable capital type and not guaranty or permanent reserve shares.

CONCLUSION.

The respondents have seized the opportunity granted them to answer the Petition for Writ of Certiorari and have employed it to present a full-scale brief on the merits. It is not the office of such a petition to present the petitioner's full case on the merits. Nor is it the office of an answer to present respondents' full case on the merits as their argument for denial of the petition. Upon analysis there is no point which the respondents have made in either of the briefs which is now valid. They have provided the Court with a preview of the many fallacies upon which their arguments directed to the merits are based.

Respectfully submitted,

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In the
Supreme Court of the United States
OCTOBER TERM, 1966

ALEXANDER TCHEREPNIN, MING TCHEREPNIN, CHARLES
NOLL, MAYBELLE NOLL, HARRY BLOCK, JEANETTE A.
BLOCK, WERNER D. BLOCK, ADRIAN DA PRATO, PETER
DA PRATO, FREDERICK D. WAHL, ANNE W. WAHL,
THEODORE MACHATKA, MARIE B. MACHATKA, JOSEPH
NOVAK, FRANCES NOVAK, MARYBETH SIMJACK, WALTER
R. ANDERSON and HELEN K. KELLOGG, *Petitioners,*
vs.

JOSEPH E. KNIGHT, JUSTIN HULMAN, CITY SAVINGS AS-
SOCIATION, DENNIS KIRBY, HARRY HARTMAN, LOUIS
KWSMAN, ROBERT FRANZ, STANLEY PASKO, JOSEPH
TALARICO, JR., HERBERT J. HOOVER, ROBERT M. KRAM-
ER, C. ORAN MENSIEK and GLORIA MENSIEK SPRINCOZ,
Respondents.

On Petition For A Writ of Certiorari to the United States Court
of Appeals For the Seventh Circuit.

**MEMORANDUM IN OPPOSITION TO THE MEMORAN-
DUM OF THE SECURITIES AND EXCHANGE COM-
MISSION AS AMICUS CURIAE**

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**In the
Supreme Court of the United States**

OCTOBER TERM, 1966

No. 1301

**ALEXANDER TCHEREPNIN, MING TCHEREPNIN, CHARLES
NOLL, MAYBELLE NOLL, HARRY BLOCK, JEANETTE A.
BLOCK, WERNER D. BLOCK, ADRIAN DA PRATO, PETER
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THEODORE MACHATKA, MARIE B. MACHATKA, JOSEPH
NOVAK, FRANCES NOVAK, MARYBETH SIMJACK, WALTER
R. ANDERSON and HELEN K. KELLOGG,**

Petitioners,

vs.

**JOSEPH E. KNIGHT, JUSTIN HULMAN, CITY SAVINGS AS-
SOCIATION, DENNIS KIRBY, HARRY HARTMAN, LOUIS
KWASMAN, ROBERT FRANZ, STANLEY PASKO, JOSEPH
TALARICO, JR., HERBERT J. HOOVER, ROBERT M. KRAM-
ER, C. ORAN MENSİK and GLORIA MENSİK SPRINCZ,**

Respondents.

On Petition For A Writ of Certiorari to the United States Court
of Appeals For the Seventh Circuit.

**MEMORANDUM IN OPPOSITION TO THE MEMORAN-
DUM OF THE SECURITIES AND EXCHANGE COM-
MISSION AS AMICUS CURIAE**

DISCUSSION

Respondents, City Savings Association, Louis Kwasman,
Harry Hartman and Dennis Kirby, are filing this memo-
randum in response to the memorandum for the Securities

and Exchange Commission in support of the petition for a writ of certiorari, which was filed after these respondents had filed their brief in opposition to the petition for a writ of certiorari.

The statement of the case, as recited by the Securities and Exchange Commission, is generally correct, except that the assets of City Savings Association are not now in the custody of the Director of Financial Institutions of the State of Illinois as set forth, but, on the contrary, are in custody of the liquidators who were appointed pursuant to the Plan of Liquidation adopted in conformity with the Illinois Savings & Loan Act.

The same cannot be said, however, of the representations of the Commission as to the supposed importance of the case at bar. The Commission never addresses itself to the proposition that the depositors in Illinois savings and loan associations are entitled to "rescission" as a matter of law. *Ill. Rev. Stat. ch. 33, §§762(a), 773(a) (1965)*. Given the right to rescind under state law, application of the "fraud provisions" of the 1934 Act are immaterial, and are merely merely cumulative of rights already possessed, assuming for sake of argument that the Act is applicable.

In an effort to make the case seem important, the Commission states that more than 100 billion dollars have been invested in savings and loan associations, 96% of which were insured by the Federal Savings and Loan Insurance Corporation, and then makes this astonishing statement: "The decision of the Court of Appeals withholds from a large portion of the investing public the protection afforded by the antifraud provisions of the 1934 Act . . ." (SEC Memo, p. 4) If 96% of the deposits are with institutions

regulated by the Federal Savings and Loan Insurance Corporation, and all are entitled to immediate rescission, the need for the application of the 1934 Act seems slight indeed.

Similarly, the SEC argument as to the effect of exempting brokers and dealers is wholly unsound, for there are no brokers and dealers in withdrawable capital accounts [if for no other reason that the accounts are not negotiable of a matter of law. Ill. Rev. Stat. ch. 32, §768 (1965)]. Surely the Commission must be confusing the permanent reserve shares with withdrawable capital accounts in making the argument it does on pages 6 and 7. There is wholly absent from this record the slightest indication that there has ever been a sale of withdrawable capital account. Obviously there can be no brokers or dealers in withdrawable capital accounts, and this supposed claim of importance is unfounded.

The SEC reasons that this case is important to its role in administering the securities laws because millions of Americans have invested in savings and loan associations. However, the SEC has previously failed to consider savings and loan associations as playing a significant role in the nation's capital market. This is evidenced by the failure of the SEC Special Study of Securities Markets to deal at all with savings and loan withdrawable capital accounts. This five volume study, completed in 1963, dealt with numerous securities and the operation of securities markets. The complete failure of the SEC to treat withdrawable capital accounts can only mean that withdrawable capital accounts are not commonly thought of as securities, that the SEC does not believe them important in the

functioning of the nation's capital market, and that the SEC is not concerned with regulating purchases of withdrawable capital accounts.

In its attempt to convince this Court of the need for review of the decision below, the SEC urges that the lower Court's decision conflicts with principles enunciated by this Court in *SEC v. C. M. Joiner Leasing Corp.*, 320 U.S. 344 (1951) by restricting the application of the 1934 Act to instruments commonly known as securities. As pointed out in these Respondents' brief in opposition to the petition for a writ of certiorari (Brief in Opposition, pp. 4-5.), the Court's opinion is not so restrictive and does not restrict the application of the 1934 Act to instruments commonly known as securities. To the contrary, the decision below leaves standing numerous cases holding that instruments (many of which were not commonly known as securities) were securities under the 1934 Act.

The balance of the argument of the SEC is based upon the exemptions from registration found in the 1933 and 1934 Acts. [See Securities Act of 1933, §3(a)(15), 15 U.S.C. §77c(a)(5) (1964); Securities Exchange Act of 1934, §12(g)(2)(c), 15 U.S.C. §78l(g)(2)(c) (1964)]. The SEC argues that such exemptions indicate a Congressional intent that withdrawable capital accounts are securities in the first instance. A similar argument was made in the court below and was properly rejected. *Tcherepnin v. Knight*, 371 F.2d 374, 378-79 (7th Cir. 1967), (App. to Pet. 28-29.) A similar exemption exists in the 1933 Act for insurance policies. See Securities Act of 1933, §3(a)(8), 15 U.S.C. §77c(a)(8) (1964). But this exemption, although creating a negative implication that insurance policies are securities [*Loss, Securities Regulation* 497 (2d Ed. 1961)] has been interpreted by the SEC as not

implying that insurance policies are securities. See Hearings before Subcom. of Senate Com. on Banking and Currency on S. 2408, 81st Cong. 2d Sess. 33 (1950); *Loss, Securities Regulation* 497 (2d Ed. 1961). See also *SEC v. Variable Annuity Life Insurance Co.*, 359 U.S. 65, 74 n.4 (1959) (concurring opinion).

7 The Commission implies that the Court below erred in rejecting petitioners' argument that withdrawable capital accounts are investment contracts, certificates of interest or participation in any profit sharing agreement, transferable shares, or stock. While it may be true that withdrawable capital accounts possess some of the characteristics of each of those descriptive terms, nevertheless the court below correctly concluded that Congress did not intend withdrawable capital accounts to be securities. A whole-life insurance policy in a mutual insurance company possesses many of these attributes; yet, insurance policies admittedly are not securities. See *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65, 74 N. 4 (1959) (concurring opinion).

The phrases which are urged as including withdrawable capital accounts were designed by Congress to include novel and unique schemes not then known to Congress. As reflected in the definition, Congress specifically included all of those interests known to it which it desired to regulate. Withdrawable capital accounts were well known to Congress at this time and their failure to be included in the definition is evidence of Congressional intent that they be excluded.

The Commission finds no significance in the omission of the phrase "evidence of indebtedness" from the 1934 Act's definition of security. However, that omission

coupled with the specific inclusion by name of other evidences of indebtedness can only lead to the conclusion that Congress intended to exclude all evidence of indebtedness not specifically included. That Congress felt that withdrawable capital accounts possessed some of the characteristics of evidence of indebtedness is set forth in the Hearings on S. 875 before the Senate Committee on Banking and Currency, 73rd Cong. 1st Sess. 94-120.

Conclusion

For the reasons stated above and for the reasons stated in the brief in opposition to the petition for a writ of certiorari, these respondents respectfully pray that the petition for a writ of certiorari be denied.

Respectfully submitted,

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In the Supreme Court of the United States

OCTOBER TERM, 1967

No. 104

ALEXANDER TCHEREPNIN, ET AL., PETITIONERS

v.

JOSEPH E. KNIGHT, ET AL.

**ON WRIT OF CERTIORARI TO THE UNITED STATES
COURT OF APPEALS FOR THE SEVENTH CIRCUIT**

**BRIEF FOR THE SECURITIES AND EXCHANGE
COMMISSION AS AMICUS CURIAE**

OPINIONS BELOW

The opinion of the district court (R. 29) has not been reported. The opinions of the court of appeals (R. 43) are reported at 371 F. 2d 374.

JURISDICTION

The judgment of the court of appeals was entered on January 20, 1967 (R. 65). The petition for a writ of certiorari was filed on April 20, 1967, and was

granted on June 5, 1967 (R. 66). This Court's jurisdiction rests upon 28 U.S.C. 1254(1).

STATUTE INVOLVED

Section 3(a)(10) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(10) provides:

3. (a) When used in this title, unless the context otherwise requires—

* * * *

(10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust, certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

QUESTION PRESENTED

Whether a withdrawable capital share in a savings and loan association is a "security" under the Securities Exchange Act of 1934.

THE INTEREST OF THE SECURITIES AND EXCHANGE COMMISSION

The federal securities laws comprise a regulatory scheme designed to foster the integrity of the nation's capital market and to afford a means of protection for members of the investing public. The Securities and Exchange Commission is charged with the administration and enforcement of those laws. The Securities Exchange Act of 1934 alone among the federal securities laws gives the Commission authority to promulgate rules and regulations that define unlawful "manipulative and deceptive" practices in connection with securities transactions (Section 10(b), 15 U.S.C. 78j(b)), and to regulate brokers and dealers who solicit or otherwise deal with the investing public (Section 15, 15 U.S.C. 78o).

The decision of the court of appeals that a withdrawable interest in a savings and loan association is not a "security" as defined in that Act, not only renders unavailable to a large number of investors¹ private remedies under the Act² but would seem to

¹ In May 1967, more than \$113 billion of savings capital were invested in more than 41 million accounts in the 4,497 savings and loan associations insured by the Federal Savings and Loan Insurance Corporation, representing about 96% of the resources of all operating savings and loan associations. Federal Home Loan Bank Board, *FSLIC Insured Savings and Loan Associations, Savings and Mortgage Lending Activity—Selected Balance Sheet Data, May 1967*, Table 3 (June 1967).

² The decision of the court of appeals does not affect the applicability to savings and loans shares of the antifraud provisions contained in Sections 12(2) and 17 of the Securities Act of 1933 (15 U.S.C. 77l(2) and 77q). But those provisions

preclude the Commission from acting for their protection.³

The decision would also exempt brokers and dealers in such shares from the registration requirements of Section 15 (15 U.S.C. 78o), and the various obligations the Act imposes upon brokers and dealers. A number of registered broker-dealers are engaged in the solicitation of funds for deposit in savings and loan accounts. Finally, the restrictive meaning the court of appeals has given to the statutory defini-

would not be fully effective in preventing misleading and manipulative practices. The 1934 Act covers not only fraud by sellers but also fraud by purchasers of securities. Fraud in the purchase of savings and loan share accounts could occur whenever there may be uncertainty as to the time or amount of payment, as when an association is in liquidation, and the owners of such accounts are induced to sell them by misrepresentations as to the amount they are likely to realize, how long the liquidation will take, etc. Moreover, Section 10(b) of the 1934 Act and Rule 10b-5 apply to fraud "in connection with" securities transactions, and thus have a broader reach than the antifraud provisions of the 1933 Act, which only cover fraud "in" such transactions.

³ The prevention of deceptive and manipulative practices through litigation under Section 10 of the 1934 Act has constituted an important aspect of the Commission's work. See, e.g., *Securities and Exchange Commission v. Texas Gulf Sulphur Co.*, 258 F. Supp. 262 (S.D.N.Y.) (appeal pending); *Securities and Exchange Commission v. Georgia Pacific Corp.*, No. 66 Civ. 1215 S.D.N.Y. (May 23, 1966); *Securities and Exchange Commission, 32d Annual Report* (1966), pp. 114-116. Section 10b has also become an increasingly effective tool in the hands of private litigants. See, e.g., *Vine v. Beneficial Finance Co.*, CCH Fed. Sec. Rep. ¶ 91,906 (C.A. 2); *Hooper v. Mountain States Securities Corp.*, 282 F. 2d 195 (C.A. 5).

tion of the term "security," if allowed to stand, would seriously hamper the Commission's efforts to deal with novel types of financial instruments as they appear.

STATEMENT

This is an action brought by a group of holders of withdrawable capital shares of respondent City Savings Association. City Savings is a corporation doing business under the Illinois Savings and Loan Act (32 Ill. Rev. Stat. 701-944). Its capital is represented exclusively by withdrawable capital accounts, evidenced "by one or more appropriate certificates * * *." ⁴ Each holder of one or more withdrawable shares is a member of the association (Section 741(a) (1)), entitled to "the vote of one share for each one hundred dollars of the aggregate withdrawal value of such accounts" or fraction thereof at meetings of the members (Section 742(d) (2)). ⁵ The profits, if any, of such associations are apportioned, at least annually, by the declaration of dividends "on withdrawable shares

⁴ 32 Ill. Rev. Stat. 768(a). Such certificate "or an account book, or both" must be delivered to the shareholders. *Ibid.* Although the Illinois statute permits an association's capital to be "represented by withdrawable capital accounts (shares and share accounts) or permanent reserve shares or both * * *" (32 Ill. Rev. Stat. 761(a)), it does not appear that the respondent association has ever issued anything except withdrawable capital shares.

⁵ Every borrower from the association, so long as his loan remains unpaid, is also deemed a member (32 Ill. Rev. Stat. 741(a) (2)), although a borrowing member is entitled only to the vote of one share as such (Section 742(d) (4)).

and share accounts" (Section 778(a)). City Savings is being liquidated.

The complaint alleges that the "capital shares issued by and capital account interests in City Savings" that were purchased by petitioners (R. 4) are securities within the meaning of Section 3(a)(10) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)(10)), that petitioners purchased such securities in reliance upon printed solicitations received from City Savings through the mails (R. 5), and that such solicitations contained false and misleading statements violative of Section 10(b) of the Securities Exchange Act (15 U.S.C. 78j(b)) and of the Commission's Rule 10b-5 thereunder (17 CFR 240.10b-5) (R. 5). In particular, the complaint alleges that the solicitations represented City Savings to be a financially strong association and its shares to be a desirable investment but failed to disclose, *inter alia*, that the association was controlled by a person previously convicted of mail fraud involving savings and loan associations (R. 7), that the association had been denied federal insurance of its shareholder accounts because of its unsafe financial policies (R. 10), and that the association had been forced to restrict withdrawals by holders of previously purchased shares (R. 10-11). Petitioners allege that sales of shares in these circumstances were void under Section 29(b) of the Securities Exchange Act (15 U.S.C. 78cc(b)), and they seek rescission (R. 6):

The Court of Appeals for the Seventh Circuit (Judge Cummings dissenting) held that the complaint should have been dismissed by the district court

because the withdrawable capital shares were "not encompassed in the definition of a 'security' under the 1934 [Securities Exchange] Act" (R. 52).

SUMMARY OF ARGUMENT

Section 3(a)(10) of the Securities Exchange Act of 1934 broadly defines "security" to include, among other things, any "investment contract," "certificate of interest or participation in any profit-sharing agreement," "transferable share" and "stock." The substantially identical definition of "security" in the Securities Act of 1933 includes the same terms, and there is no reason to believe that Congress intended them to have any narrower meaning in the 1934 Act than in the earlier one. Under this Court's decisions in *Securities and Exchange Commission v. C. M. Joiner Leasing Corp.*, 320 U.S. 344, and *Securities and Exchange Commission v. W. J. Howey Co.*, 328 U.S. 293—both cases under the 1933 Act—an "investment contract" was defined as involving "an investment of money in a common enterprise with profits to come solely from the efforts of others" (*Howey*, 328 U.S. at 301). This would clearly include a share account in a savings and loan association. Share accounts also come within the three other terms listed above, since they represent the capital of the enterprise, are transferable by assignment, and entitle the holder to participate in profits realized in the operations of the business.

The court of appeals erroneously assumed that the meaning of these terms was limited by the catch-all

phrase at the end of the definition, "any instrument commonly known as a 'security'." In the *Joiner* case this Court rejected a similar attempt to qualify the broad terms of the definition in the 1933 Act, and the same reasoning is equally applicable here. The court of appeals also erred in assuming that only those interests that are speculative, fluctuate in value and are traded on organized markets constitute a security. See *Howey, supra*.

The legislative history of the Securities Act of 1933 shows that Congress in passing that Act recognized that share accounts in savings and loan associations were covered by the definition of "security." Congress, however, exempted such shares from the registration requirements of the 1933 Act because of the burdens of such registration, but made them subject to the Act's antifraud provisions. Representatives of the savings and loan industry recognized during the hearings on the 1933 Act that they would be subject to the latter provisions.

Since savings and loan shares were clearly understood to be within the definition of "security" adopted by Congress for the 1933 Act, it would take compelling evidence to demonstrate that such shares are not covered by the substantially identical definition adopted by the same Congress for the 1934 Act. No such evidence has been presented. Indeed, the complete silence of the legislative history of the 1934 Act with respect to savings and loan shares is inconsistent with the supposition that Congress abruptly departed from its earlier understanding that such shares are securities.

The fact, which the court of appeals deemed significant, that the phrase "evidence of indebtedness" is included in the definition of security in the 1933 Act but not included in the 1934 Act, is irrelevant. Since, as we have shown, share accounts are covered by several terms common to both Acts, the omission of the term "evidence of indebtedness" is immaterial. The omission is further irrelevant here because petitioners are not creditors and their share accounts represent an equity rather than a debt interest.

Finally, the conclusion that share accounts are securities under the 1934 Act is supported by the Commission's settled administrative interpretation of that Act. The Commission repeatedly has taken actions resting upon a determination that such accounts are covered by the Act, and Congress in 1964 confirmed and approved the Commission's view.

ARGUMENT

A Share Account in a Savings and Loan Association Is a "Security" Under the Securities Exchange Act of 1934.

A. The Definition of "Security" in Section 3(a)(10) of the Act Covers Share Accounts.

Section 3(a)(10) of the Securities Exchange Act of 1934 broadly defines "security" to include, *inter alia*,

any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment con-

tract, voting-trust certificate, certificate of deposit for a security, or in general, any instrument commonly known as a 'security'. * * *

This definition is substantially the same as the definition of "security" in the Securities Act of 1933.⁶ There is nothing to indicate that when Congress used the same words in both Acts it intended them to be construed more narrowly in the later than in the earlier one; and if the same Congress which passed the Securities Act of 1933 intended to narrow the reach of the additional protections that it gave to investors one year later, it presumably would have given some indication of such an intent. Thus, if a share account in a savings and loan association is a security under the 1933 Act,⁷ it is also a "security" under the 1934 Act, if it is within any of the terms common to both acts.

⁶ Section 2 of the Securities Act of 1933, 15 U.S.C. 77b, provides:

When used in this title, unless the context otherwise requires—

(1) the term "security" means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security". * * *

⁷ We shall refer to the Securities Act of 1933 as the "1933 Act" and to the Securities Exchange Act of 1934 as the "1934 Act."

The decisions of this Court in *Securities and Exchange Commission v. C. M. Joiner Leasing Corp.*, 320 U.S. 344, and *Securities and Exchange Commission v. W. J. Howey Co.*, 328 U.S. 293—both cases under the 1933 Act—leave no doubt that petitioners' share accounts in City Savings constitute "investment contracts" within the meaning of both definitions. In *Howey* the Court pointed out that although "[t]he term 'investment contract' is undefined by the Securities Act or by relevant legislative reports * * *, it had been broadly construed by state courts so as to afford the investing public a full measure of protection. Form was disregarded for substance and emphasis was placed upon economic reality" (328 U.S. at 298). Stressing the "economic reality" of the interest there involved, the Court ruled that when a "person invests his money in a common enterprise and is led to expect profits solely from the efforts of * * * a third party," his interest, "regardless of the legal terminology in which * * * [it might be] clothed," is an "investment contract" (328 U.S. at 299-300).

Petitioners, too, have invested their capital in a common enterprise—a money lending business with prospects for success dependant upon the skill of the managers in making suitable loans upon adequate security. If the managers are unskilled, improvident or dishonest, the purchasers of the share accounts are likely not only to forego any return on their investment but also to lose a substantial part thereof—as petitioners all too well know.⁸

⁸ The court below apparently rejected application of the *Howey* test in part because "[t]he profit is derived from

Petitioners' interests "on their face * * * answer to the name or description" of certain of the other categories set forth in the definition of "security". *Joiner, supra*, 320 U.S. at 351. The attributes of a withdrawable capital share under the Illinois Savings and Loan Act, pursuant to which it is issued, make it a "certificate of interest or participation in any profit-sharing agreement," a "transferable share," and "stock." The profit-sharing nature of the agreement (required to be evidenced by a certificate, 32 Ill. Rev. Stat. 768(a)) to which the petitioners became parties by their purchase is shown by the statutory provision that "[d]ividends * * * may be declared * * * on withdrawable shares and share accounts" after provi-

loans to other members of the savings and loan association. This is not investment in a common enterprise with profits to come solely from the efforts of others" (R. 48-49). But the modern savings and loan association does not, as the court's language suggests, restrict its investments to loans to account holders. In Illinois, for example, an association may invest not only in obligations of members, 32 Ill. Rev. Stat. 791, but may also make other loans or other investments, *id.* 792-792-10. The fact that all borrowers and all obligors of other investments become "members" by virtue of such loan or investment, whether or not they are capital account holders, see *id.* 741, is irrelevant to application of the principles set forth in *Howey*. Furthermore, there is no suggestion in the Illinois Act that shareholders, as such, are entitled to participate in management decisions. Profits of the association, if any, depend entirely upon the manner in which the board of directors exercises its authority to conduct the business and affairs of the association, see 32 Ill. Rev. Stat. 744, and if shareholders usually give irrevocable proxies, as the court below suggests (R. 47), such shareholders surrender even residual control of their investment to the corporate management.

sion has been made for reserves. 32 Ill. Rev. Stat. 778. The interests involved are transferable shares since the statute provides that "the holder of a withdrawable capital account may transfer his rights therein absolutely or conditionally to any person eligible to hold the same * * *." *Id.* 768(b).⁹

⁹ The term "share" is used in conjunction with every significant right which petitioners obtained by virtue of their purchases. See, e.g., 32 Ill. Rev. Stat. 741 (membership); *id.* 742(d) (2) (voting); *id.* 778(c) (participation in profits as dividends). See also Reply to Briefs in Opposition, p. 3, for an exhaustive analysis of that and similar terms employed in the Illinois Act. In this respect, the provisions of the Illinois statute appear to be typical. See Bodfish, *Savings and Loan Principles* (1938) pp. 130-131:

Savings and loan shares are founded upon many of the same fundamental principles as shares in other corporations. They represent portions of ownership in the assets of the association. * * * It gives its owner the right to participate in the designation of the management of the business, to undertake the risk of loss, and to share in the profits. Savings and loan association shares differ from stock in most other corporations, however, in one important aspect. The association has the right under the laws to repurchase its own shares and, when its funds are available, must do so if account holders wish to withdraw.

The members of the congressional committees which held the hearings on both the 1933 Act and the 1934 Act repeatedly referred during the hearings on the former to interests in savings and loan associations as "shares" and "stock." See Hearings on H.R. 4314 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 1st Sess. 70-80 *passim* (1933); Hearings on S. 875 before the Senate Committee on Banking and Currency, 73d Cong., 1st Sess. 50-54, 99-101, 110-113 *passim* (1933).

See, also, *Fahey v. Mallonee*, 332 U.S. 245, 255, 257; *Veix*

Finally, contrary to the apparent view of the court of appeals, the catch-all phrase at the end of the definition, "any instrument commonly known as a 'security,'" does not limit the reach of the preceding words in the definition.¹⁰ Rather, it expands the definition to

v. Sixth Ward Bldg & Loan Assn., 310 U.S. 32, 34, 35, 36, 38, 40; *Treigle v. Acme Homestead Assn.*, 297 U.S. 189, 191, 192, 193, 197; *Hopkins Fed. Sav. & Loan Assn v. Cleary*, 296 U.S. 315, 327, 329, 331, 332, 333, 336, 339, 340, 341; *Bedford v. Eastern Bldg. and Loan Assn.*, 181 U.S. 227, 237, 238, 239, 240-242.

¹⁰ The court of appeals' analysis of the ways in which share accounts differ from "the ordinary concept of a security" (R. 47) will not bear scrutiny. The attributes emphasized by the court do not determine the existence of a security, but merely distinguish among securities of different types, since interests which are indisputably securities possess these characteristics. Thus, like interests in savings and loan associations, shares of mutual funds may be issued in unlimited amounts and without preemptive rights (see *Report of the Securities and Exchange Commission on the Public Policy Implications of Investment Company Growth*, H. Rep. No. 2237, 89th Cong., 2d Sess. 54-55, 201 (1966)), and they may be redeemed at the option of the shareholders at any time (see Sections 2(a) (31) and 5(a) of the Investment Company Act of 1940, 15 U.S.C. 80a-2(a) (31) and 80a-5(a)). See also *Securities and Exchange Commission v. United Benefit Life Insurance Company*, 387 U.S. 202, 205. A right of retirement by the issuer is a frequent incident of preferred stock (see 11 Fletcher, *Cyclopedia Corporations* § 5309, pp. 912-914 (1958 rev.)). That savings and loan interests may be transferable only by assignment and are not made subject to the Uniform Commercial Code merely reflects the fact that this type of security is not a usual medium for trading in the markets. This is equally true of the type of investment contracts in the *Joiner* and *Howey* cases. Similarly, holders of the types of interests involved in those cases would presumably

cover other forms of joint investment participation in a common enterprise for profit. "[T]he reach of the Act does not stop with the obvious and commonplace." *Securities and Exchange Commission v. C. M. Joiner Corp.*, 320 U.S. at 351. In the *Joiner* case this Court refused to "read out of the statute * * * general descriptive designations merely because more specific ones have been used to reach some kinds of documents" (p. 351), and refused to "constrict the more general terms substantially to the specific terms which they follow" (p. 350). And in *Llanos v. United States*, 206 F. 2d 852, 854 (C.A. 9), certiorari denied, 346 U.S. 923, the court rejected the contention that a similar phrase in the 1933 Act "limits those which come before."

Noting that the 1933 and the 1934 Acts "were passed in the aftermath of the great economic disaster of 1929," the court below suggested that in determining whether an interest is a security, weight should be given to whether it is speculative, of a fluctuating value and traded on an organized market (R. 47, 49, 51), and it stressed the absence of these qualities in

not be "entitled to inspect the general books and records" of the issuer (R. 47). Indeed, this is a right available only under unusual circumstances to corporate bondholders. As Judge Cummings showed in his dissenting opinion (R. 60-61), there is no warrant for the assumption that the Illinois legislature did not regard share accounts as securities. But even if the court of appeals were correct in supposing that "the Illinois legislature did not intend [share accounts] to be securities" (R. 47), its conclusion that they are, therefore, not "commonly known as a security" is a *non sequitur*,

share accounts. This Court rejected a similar test in *Howey*, however, where it said:

We reject the suggestion of the Court of Appeals, 151 F. 2d at 717, that an investment contract is necessarily missing where the enterprise is not speculative or promotional in character * * *. The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others. If that test be satisfied, it is immaterial whether the enterprise is speculative or non-speculative * * *. [328 U.S. at 301.]

In other words, whether particular interests are "securities" under the 1933 or the 1934 Act does not depend upon whether they are speculative or regularly traded, but whether they constitute the kind of interest to which Congress intended the protections of the federal securities laws to apply. In any event, the fact is that share accounts have been actively traded on at least one organized securities market, and the regulatory provisions of the 1934 Act were then assumed to be applicable. See *infra*, p. 23.

B. Congress Plainly Intended the Term "Security" in the Securities Act of 1933 to Include Share Accounts, and it did not Intend that Term to Have Any Narrower Meaning Under the 1934 Act.

1. Congress plainly intended to treat share accounts as securities when it passed the 1933 Act. The testimony before the congressional committees shows that savings and loan associations were known to be subject to the abuses that the Act was aimed at. Mr.

Huston Thompson, a former member of the Federal Trade Commission who had been active in drafting the bill, testified before the Senate committee that the building and loan association was "a favorite title for the blue-skyer to use, and he has certainly used it over this country, and it has caused great loss." *Senate Hearings, supra*, p. 99. Another witness testified before the House committee that "in the East the good name of the building and loan associations has been used by some promoters for most fraudulent purposes." *House Hearings, supra*, p. 75. A senator observed that he did "not know of any set of organizations that need regulation and supervision in the matter of the selling of their stock any more than building and loan associations." *Senate Hearings, supra*, p. 111.

Moreover, the representatives of the savings and loan industry apparently recognized that they would be subject to the Act, and sought an exemption from its registration provisions on the ground that the small associations, which made continuous offerings of their shares, would find it extremely burdensome to comply with those requirements. Those industry representatives were explicit that they sought only a limited exemption and repeatedly professed to welcome the coverage of their companies by the Act's antifraud provision.¹¹ For example, Morton Bodfish, executive

¹¹ See Hearings on H.R. 4314 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 1st Sess. 70-80 (1933) (testimony of Mr. Morton Bodfish, Executive Manager, United States Building and Loan League); Hearings on S. 875 before the Senate Committee on Banking and Cur-

manager of the United States Building and Loan League, testified before the House committee: ¹²

When a person saves his money in a building and loan association, he purchases shares and nearly all of our \$8,000,000,000 of assets are in the form of shares * * *.

The practical difficulties of an association having to register every issue of shares with the Federal Trade Commission are obvious. * * *

* * *

I would emphatically point out to the committee that we are in accord with [the antifraud provisions] which would apply to all of our associations if there are any improper or fraudulent or deceptive practices. The exceptions to the submission of reports and the like * * * do not apply to [the antifraud provisions] * * *.

* * *

Now, gentlemen, we want you to leave the fraud sections there, just as they are, so that any fraud developed in connection with the management of any of our institutions anywhere or under the name of building and loan, this law can be effective and operative.

We do think, as a practical matter, you should leave these 11,442 building and loan associations, which are mainly small community institutions, out from the routine reporting and registering of their securities every time they start to issue more stock * * *.

rency, 73d Cong., 1st Sess. 50-54 (1933) (testimony of Mr. C. Clinton James, Chairman, Federal Legislative Committee of the United States Building and Loan League).

¹² House Hearings, *supra*, pp. 71-74.

In accordance with this and similar requests, savings and loan securities were added to the list of "exempted securities" in Section 3(a) of the Act. If share accounts were not covered by the definition of "security" in the 1933 Act, there was neither need nor occasion to give them such an exemption.

This background demonstrates that savings and loan shares were understood to be included in the general definition of "security," but were exempted from the provisions of the 1933 Act other than the anti-fraud provisions. Certainly the savings and loan industry has never doubted it.¹³ Nor has the Securities and Exchange Commission or the courts.¹⁴

2. Since savings and loan shares are clearly within the definition of "security" adopted by Congress for

¹³ See Richards, *The Federal Securities Act*, 1933 Building and Loan Annals 111; American Savings, Building & Loan Institute, *The Federal Securities Act—a Building and Loan Problem*, Savings and Loans, November, 1933, p. 3. See also p. 26, *infra*.

¹⁴ See *W. K. Archer & Co.*, 11 S.E.C. 635, 643-644, affirmed, 133 F. 2d 795 (C.A. 8), certiorari denied, 319 U.S. 767. The Commission has obtained consent decrees in injunction actions for violations of Section 17(a) of the Securities Act in the sale of savings deposit pass books of savings and loan associations. *Securities and Exchange Commission v. First Capital Savings and Loan Association* (D. Md., 60 Civ. 12115, May 3, 1960); *Securities and Exchange Commission v. American Seal Savings and Loan Association* (D. Md., 60 Civ. 12172, June 19, 1963). The Commission has also obtained an injunction for violation of the registration provisions of that Act in the sale, *inter alia*, of "preferred stock," evidenced by deposit books, by an organization called a savings and loan association but found not to be qualified for the exemption. *Securities and Exchange Commission v. American International Savings & Loan Ass'n*, 199 F. Supp. 341 (D. Md.).

the 1933 Act, it would take compelling evidence to demonstrate that such shares were not understood to come within the virtually identical definition adopted by the same Congress for the 1934 Act. No such evidence has been presented. Indeed, so far as we have been able to ascertain, the legislative history of the 1934 Act is silent with respect to savings and loan shares. The Senate Report does state, however, that the definition of "security" in the 1934 Act was intended to be "substantially the same as [that contained] in the Securities Act of 1933." S. Rep. No. 792, 73d Cong., 2d Sess. 14 (1934).

Lacking any support in the legislative history, both the court of appeals (R. 48) and respondents (Brief in Opposition for City Savings Assoc. *et al.*, pp. 6-7, 12, 15) suggest policy reasons why the 1934 Act, and its antifraud provisions in particular, should not apply to savings and loan shares. But whatever the merit of those considerations, they prove too much; for they are equally applicable to the 1933 Act which, as shown, plainly does cover such shares. If, as we think evident, Congress understood savings and loan shares to be securities in 1933, there is no reason to believe that Congress did not regard them as securities in 1934. Indeed, there are persuasive policy reasons why Congress would not have wanted to exclude share accounts from the coverage of the 1934 Act. Those who commit their capital to a savings and loan association require the protections of the antifraud provisions of and the benefits of the Commission's broker-dealer regulation under that Act just as much as those who participate in other investment ventures.

3. The court of appeals placed great reliance on the fact that the term "evidence of indebtedness," which was included in the otherwise similar definition of "security" in the 1933 Act was omitted from the definition in the 1934 Act. There are several answers to this point. *First*, since, as shown above, share accounts are within terms defined to be securities by both the 1933 and 1934 Acts, without regard to the phrase "evidence of indebtedness,"¹⁵ its omission from the 1934 Act is irrelevant. *Second*, the point is further irrelevant in the present case since, contrary to the court's supposition, petitioners are not creditors and their share accounts are an equity rather than a debt interest.¹⁶ *Third*, since the legislative history of

¹⁵ As noted above (pp. 11-13), shares accounts come within such specified categories as "transferable share" and "investment contract." It has been held that an investment contract may be predicated on underlying debt securities. In *Los Angeles Trust Deed and Mortgage Exchange v. Securities and Exchange Commission*, 285 F. 2d 162 (C.A. 9), certiorari denied 366 U.S. 919, persons selling and servicing trust deed and mortgage notes of others were held to be issuing investment contracts, and were enjoined not only from violating the Securities Act but also from acting as unregistered dealers in securities under the Securities Exchange Act.

¹⁶ See Judge Cummings' dissenting opinion (R. 59-61) which points out that under Illinois law a holder of a withdrawable share account does not become a creditor even upon filing an application for withdrawal (32 Ill. Rev. Stat. 773 (f)). Moreover, the authority of an Illinois saving and loan association to borrow money is governed by a provision (32 Ill. Rev. Stat. 707) entirely different from that governing the issuance of share accounts (32 Ill. Rev. Stat. 761(a)). See, also, n. 9, *supra*, p. 13.

The legislative history cited by the court of appeals (Hearings on S. 875 before the Senate Committee on Banking and

the 1934 Act offers no indication as to the considerations, if any, that prompted the omission of the phrase "evidence of indebtedness," the assumption that a highly significant change was intended seems unwarranted and inherently implausible.¹⁷

C. The Commission Consistently has held Share Accounts to be Securities Under the 1934 Act.

The conclusion that share accounts are securities under the 1934 Act is further supported by the Com-

Currency, 73d Cong., 1st Sess. 94-120 *passim*) does not justify the court's statement that "[s]ome of the Senators evidently saw a relationship between this term 'evidence of indebtedness' and accounts in building and loan associations * * *" (R. 50).

¹⁷ As an ancillary argument, the court of appeals suggested that share accounts are "mature at issue" and, therefore, fall within the 1934 Act's exclusion of notes maturing within nine months (R. 47). This argument is untenable. First, of all, the exclusion of short-term commercial paper under the 1934 Act, and its exemption under the 1933 Act, were responsive to the particular needs of a distinct type of commerce having nothing in common with share accounts. See, *e.g.*, Hearings on S. 875 before the Senate Committee on Banking and Currency, 73d Cong., 1st Sess. pp. 94-95. Secondly, had the 1933 Act's exemption for short-term paper (Section 3(a)(3)) been thought to cover savings and loan association securities, there would have been no reason to provide a separate exemption for "[a]ny security issued by a * * * savings and loan association * * *" (Section 3(a)(5)). Finally, the fact that withdrawable capital share accounts may be said to be "mature at issue" in the sense that the investment may be immediately withdrawn does not distinguish them from variable annuities (see *Securities and Exchange Commission v. United Benefit Life Ins.*, 387 U.S. 202, 205) or mutual fund shares (see Sections 2(a)(31) and 5(a) of the Investment Company Act of 1940, 15 U.S.C. 80a-2(a)(31) and 80a-5(a)), both of which are securities.

mission's settled administrative interpretation of that Act.

In 1934, within a few months after the passage of the Act, the Commission, on application of the Cleveland Stock Exchange, temporarily exempted from the provisions of Sections 7, 8, 12 and 13 of that Act, "[p]ass books of * * * savings and loan companies" which at that time were being "traded in on the Cleveland Stock Exchange * * *." See Securities and Exchange Commission Release No. 26, October 22, 1934. In 1942, pursuant to Section 15(b) of the Act, the Commission revoked the registration of a broker and dealer in securities based, *inter alia*, upon a fraudulent sale of savings and loan association certificates, on the ground that the transaction violated both Section 17(a) of the 1933 Act and Section 15(c)(1) of the 1934 Act. *W. K. Archer & Co.*, 11 S.E.C. 635, 643-644, *affirmed*, 133 F. 2d 795 (C.A. 8), certiorari denied, 319 U.S. 767.¹⁸ Both of these actions necessarily were grounded on the premise that share accounts are securities under the 1934 Act.

The Commission has also required securities brokers and dealers whose business is exclusively the solicitation of funds for deposit in savings and loan accounts to register with the Commission pursuant to Section

¹⁸ The record before the court of appeals in that case demonstrates that the certificates evidenced withdrawable stock; see Petitioner's Abstract of Record, pp. 179-181, *Archer v. Securities and Exchange Commission*, Sup. Ct. No. 1005, O.T., 1942, and the court of appeals, in affirming, did not question the Commission's treatment of those certificates as securities. See 133 F. 2d at 801.

15 of the 1934 Act,¹⁹ which prohibits unregistered brokers and dealers from effecting transactions in "any security" in the over-the-counter market. Form SECO-3, which the Commission adopted on September 7, 1965, requested information about the "Principal type of Securities Business engaged in" by certain brokers and dealers and listed, as one type of such business, "Solicitor of savings and loan accounts." See SEC Securities Exchange Act Release No. 7697 (September 7, 1965). In response, 14 registered broker-dealers indicated that this was their principal type of securities business.²⁰

¹⁹ For example, B. C. Morton & Co., Inc., SEC Files No. 8-3532-1, in a certificate filed on December 29, 1961, stated that its "only business is the solicitation of funds from the public for deposit with Federal Savings and Loan Associations * * *." Federal associations are mutual institutions which issue no permanent form of capital and are not permitted to accept deposits which evidence debt. See 12 U.S.C. 1464(a) and (b); 12 CFR 554.1(a) (Chapter N, Para. 3(6)); 12 CFR 554.1(b) (Chapter K, Para. 3(6)). Some registered brokers solicit subscriptions for investment certificates as well as for withdrawable shares, see, *e.g.*, Edward L. Johnson, SEC File No. 8-10416-1, Registrants Verification, sworn to February 11, 1966 ("the securities business of Edward L. Johnson has been limited to acting as broker for eleven savings and loan associations * * * in soliciting subscriptions for investment certificates and withdrawable shares of such associations * * *"). Others may solicit funds on behalf of banks as well as savings and loan associations. See Leonard Goldberg, SEC File No. 8-4100-1, Certificate of Independent Public Accountant, filed November 30, 1966 ("* * * his business is limited to acting as agent for soliciting depositors in Savings Banks or Savings and Loan Associations").

²⁰ See SEC Files Nos.: 8-4819-1, 8-4100-1, 8-11396-1, 8-10818-1, 8-11542-1, 8-11480-1, 8-10416-1, 8-11797-1, 8-3532-1, 8-10240-1, 8-10942-1, 8-10098-1, 8-10104-1, 8-7958-1.

Congress confirmed and approved the Commission's view in 1964, when it amended the 1934 Act to cover certain issuers of equity securities. For in response to a statement by the Commission that an explicit exemption was needed if withdrawable shares of savings and loan associations were not to be covered by the new provisions,²¹ Congress specifically excluded "any security, other than permanent stock, guaranty stock, permanent reserve stock, or any similar certificate evidencing non-withdrawable capital, issued by a savings and loan association * * *." Section 12(g)(2)(C) of the 1934 Act, 15 U.S.C. 78l(g)(2)(C). It thus recognized that withdrawable shares of savings and loan institutions came within the definitions of "security" and "equity security"²² in that Act.²³

²¹ See *Technical Statement of the Securities and Exchange Commission*, Hearings on H.R. 6789, H.R. 6793 and S. 1642 before a Subcommittee of the House Committee on Interstate and Foreign Commerce, 88th Cong., 1st Sess. 211, 215 (1963); *Memorandum of the Securities and Exchange Commission*, *id.* at 1360, 1361.

²² Section 3(a)(11), 15 U.S.C. 78c(a)(11), defines "equity security" to mean "any stock or similar security * * *."

²³ Other federal agencies that regulate financial institutions have called attention to the Commission's position. Identical letters dated December 16, 1966 from the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Home Loan Bank Board and the Board of Governors of the Federal Reserve System, to the banks and savings and loan associations within their respective regulatory jurisdictions, called attention to the Commission's opinion that "deposit and share accounts are subject to the anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934 and that advertisements by financial institutions that are

Finally, a representative of the savings and loan industry recently pointed out that the industry itself has long viewed its activities as subject to the antifraud provisions of both the 1933 and the 1934 Acts. The United States Savings and Loan League,²⁴ in commenting upon the granting of the petition for certiorari in this case, noted that the Commission "contends that deposits and accounts in savings and loan associations are subject to the antifraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934." It stated, however, that "[t]his case is not necessarily as significant and earth shaking in its implications as many savings and loan people assume. In the first place *the savings and loan business always has assumed that it was subject to the antifraud provisions of the Securities Acts* relating to advertising practices, etc. Regardless of how this case goes it does not mean that savings and loan associations will be any more involved with the SEC than they have been in the past. * * *

" (emphasis added).

contrary to such principle may violate those anti-fraud provisions." See The New York Times, December 19, 1966, p. 1, col. 1; p. 22, cols 4-5.

²⁴ United States Savings and Loan League, *SEC Savings and Loan Case to Supreme Court*, Membership Bulletin, June 28, 1967, p. 15.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

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SEPTEMBER 1967.

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IN THE
Supreme Court of the United States

OCTOBER TERM, 1967.

No. 104

ALEXANDER TCHEREPNIN, et al.,
Petitioners,

vs.

JOSEPH E. KNIGHT, et al.,
Respondents.

**ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF
APPEALS FOR THE SEVENTH CIRCUIT.**

BRIEF FOR ALEXANDER TCHEREPNIN, ET AL.

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IN THE
Supreme Court of the United States

OCTOBER TERM, 1967..

No. 104.

ALEXANDER TCHEREPNIN, et al.,
Petitioners,

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Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF
APPEALS FOR THE SEVENTH CIRCUIT.

BRIEF FOR ALEXANDER TCHEREPNIN, ET AL.

OPINIONS BELOW

The opinion of the United States District Court has not been reported and is printed in the Transcript of Record herein at pages 29-33.¹ The majority and dissenting opinions of the United States Court of Appeals for the Seventh Circuit are reported in 371 F. 2d 374, and are printed of record herein at pages 43 and 53 respectively.

1. References to the Transcript of Record are hereinafter designated (R.).

JURISDICTION

The judgment of the Court of Appeals for the Seventh Circuit was entered on January 20, 1967. The petition for a writ of certiorari was filed April 20, 1967, and was granted on June 5, 1967. The jurisdiction of this Court rests on 28 U. S. C. 1254(1).

QUESTIONS PRESENTED

1. Is a withdrawable capital share issued by a state-chartered savings and loan association "stock," a "transferable share," an "investment contract," a "certificate of interest or participation in a profit-sharing agreement," or otherwise within the definition of "security" contained in Section 3(a)(10) of the Securities Exchange Act of 1934, 15 U. S. C. 78c(a)(10)?

2. Are withdrawable transferable shares in a mutual savings and loan association, which represent its only capital and entitle holders, who are not involved in the association's management, to participate in its net profits (or losses), securities within that definition, so that the anti-fraud provisions of that Act are applicable to purchases and sales of such shares?²

2. The complaint alleges that the sales of the shares here were on a restricted basis as to withdrawability (R. 13, 14). Obviously, the questions here presented as to withdrawable shares encompass the subsidiary question whether shares restricted against withdrawability are securities, and such question is comprised in the questions presented. See Rule 23(1)(c) of this Court. Sections 3(a)(13) and (14) of the Securities Exchange Act of 1934 (15 U. S. C. §§ 78c(a)(13) and (14) are involved in that subsidiary question.

STATUTE INVOLVED

Section 3(a)(10) of the Securities Exchange Act of 1934, 15 U. S. C. 78c(a)(10) provides:

3. (a) When used in this title, unless the context otherwise requires—

(10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited.

STATEMENT

1. The Nature of the Action and Parties Thereto.

This is an action pursuant to Sections 10(b) and 29(b) of the Securities Exchange Act of 1934 (15 U. S. C. §§ 78j(b) and 78cc(b)) and Rule 10b-5 promulgated thereunder (17 C. F. R. 240, 10b-5). Respondents here and defendants-appellants below are City Savings Association (hereinafter "CSA"), its officers, directors, "liquidators" and certain officials of the State of Illinois who had seized custody of CSA at the time the Complaint herein was filed.

It is brought by approximately 150 investors in the capital shares of CSA, on their own behalf and as a class action on behalf of over 5000 investors who purchased such shares between July 24, 1959 and June 26, 1964 (R. 2-5, 12). They seek to rescind the purchases and to recover the purchase prices paid for the shares of CSA allegedly fraudulently sold, as hereinafter set forth, to them (R. 6, 13, 14).

CSA is a savings and loan association chartered as a corporation under the Illinois Savings and Loan Act (hereinafter "the Illinois Act") (Ill. Rev. Stats., 1963, ch. 32 §§ 701-944).³ By §§ 706 and 708 of the Illinois Act, CSA was granted all general powers of a business corporation under the Illinois Business Corporation Act (Ill. Rev. Stats., 1963, ch. 32 §§ 157.1-157.167) and was permitted to carry on the business of a savings and loan association for its stockholders.

3. References in this Brief by section number, without other identification, are to the Illinois Act.

2. CSA's Statutory Power to Raise Capital by the Sale of Withdrawable Capital Shares and Accounts.

All of CSA's capital under the Illinois Act consisted of "withdrawable capital accounts (shares and share accounts)" (§ 761(a)).⁴ CSA solicited the purchase of such shares and share accounts by means of flamboyant sales literature sent through the United States mails to petitioners and others residing throughout the United States (R. 5, 9). As inducements, CSA offered expensive merchandise premiums and represented that CSA was of financial strength and that its securities were a desirable purchase (R. 9, 10).

Under the Illinois Act, CSA could accept payment for its shares and share accounts according to the following described plans.⁵

1. (Regular installment plan): CSA was empowered to enter into a subscription agreement with a purchaser under which the purchaser would agree to make weekly or monthly installment payments until

4. By § 761 it is made clear that when the term "withdrawable capital account" is used in the Illinois Act, it refers to "shares and share accounts". Thus, wherever the word account is used in the Illinois Act, it means "shares and share accounts". § 761 also permits capital to be secured by the sale of permanent reserve shares, but those are not here involved since CSA never sold any nor does the Complaint relate to same.

5. Exhibit A to the Peat, Marwick, Mitchell & Co. Special Report, hereinafter identified as part of the record in footnote 9, page 10, indicated that as of April 30, 1964, shortly before CSA was seized by the Department of Financial Institutions of the State of Illinois, its withdrawable capital consisted of the following:

Dues Paid on Installment Plan Shares.....	\$ 52,722.
Optional Plan Shares.....	\$ 540,070.
Pre-paid Shares	\$ 3,552,500.
Paid-up Shares	\$ 1,435,342.
Investment Shares	\$21,914,992.
Christmas Club Shares.....	\$ 16,484.

the total amount paid plus dividend credits reached the value agreed upon in the subscription, referred to in the Illinois Act as the "maturity value" (§ 762(d)(1)).

2. (Full paid plan): A purchaser could make one single payment of \$100 per unit; thereafter, dividends when and if declared and credited would be payable in cash unless by agreement they were to be retained in the account (§ 762(d)(2)).
3. (Pre-paid plan): The purchaser could make one single payment in such amount per \$100 unit as the By-Laws set forth; thereafter the share account would increase to an ultimate or "maturity value" of \$100 per unit through the Association crediting declared dividends to the account (§ 762(d)(3)).
4. (Optional Plan): The purchaser could make payments of such amounts and at such times as he elected; under this plan dividends would be credited to a holder's account unless by agreement between the holder and CSA they were made payable in cash, (§ 762(d)(4)).
5. (Bonus plan for purposes of thrift and long term investment):
 - a) The purchaser could make an agreement to make regular payments, at least monthly, of any pre-determined amount, until the payment together with dividends apportioned thereto equaled two hundred times the agreed monthly payments. If the agreement were kept, the purchaser would receive a bonus (§ 781(a)).
 - b) (Long term plan): The purchaser could subscribe to an agreement that he would maintain an agreed balance in his account for a period of 4 or 8 years. In the event the agreement were kept, he would receive a bonus at the agreed rate (§ 781(b)).

3. Withdrawability and Maturity re Capital Shares and Share Accounts.

Under the Illinois Act, holders of withdrawable capital may make application for withdrawal of, and the association may, even if it has sufficient funds on hand, either pay or refuse to honor such application (§ 773(a)). Further, the association may wait for a period of 30 days within which to determine whether it has such funds before paying any applications (§ 773(b)). Thereafter, if refusal to pay is because there are insufficient funds in the treasury and from current receipts to pay all matured accounts and applications for withdrawal within 30 days after such accounts mature or withdrawal is applied for, the Board of Directors is required under the Illinois Act to establish a rotation procedure for payments (§ 773(b)). The holder of withdrawable capital for which application for withdrawal has been made does not become a creditor by reason of such application (§ 773(f)).⁷

7. ~~To understand~~ the nature of the savings and loan business and the reason why withdrawable shares must of necessity be only conditionally withdrawable, it is necessary to comprehend the structure of the entire industry. As pointed out heretofore in the Reply of Petitioners to Briefs in Opposition to the Petition for Certiorari, pp. 9-10:

"The legislatures in all states and the Congress have carefully constructed a form of business enterprise where the debtor-creditor relationship would not exist between an association and the investors in its capital. Such capital investments generally are designedly called 'shares', 'capital accounts', and by other terms of recognized meaning which cannot be confused with banking usage.

"To understand the reason for this structuring of the entire industry, it is necessary to compare the long-term mortgage lending function of savings and loan associations with the commercial banking functions of banks, historically and at present. Because banks are subject to demand withdrawals by depositors, and have a debtor-creditor relationship with them, by necessity they have avoided freezing any substantial part of their deposits into long-term real estate mortgage loans. On December 31, 1965, of the total of almost \$378.9 billion of

When purchases under plan "1" reached the agreed value, and under plan "3" the value of \$100 per share, CSA was empowered either to pay the holder this "maturity value" of his shares directly,⁸ or to notify the shareholder that he was entitled to receive payment under the agreement or to transfer his account into other withdrawable capital (§ 774(a)). If CSA followed the notification course, then if within sixty days after the date the notice was mailed the shareholder had taken no action, the Illinois Act empowered the directors of CSA to convert the shares at their "maturity value" either into other withdrawable capital or into a so-called "creditor account" (§ 774(a)).

Except as provided otherwise in the contract between the shareholder and CSA, such capital accounts were withdrawable before reaching the agreed "maturity value" (§ 762(a)), subject to the same conditions as all other withdrawable capital purchased under other plans (§ 773, see p. 7, *supra*) and not including any portion of the "bonus reserve" (§ 781) which may have been retained

assets of commercial banks in the United States, only 13.1% was invested in such loans. (Rep. of Call 74, Dec. 31, 1965, FDIC, Washington, D. C., p. 2.)

"Savings and loan associations on the other hand were created and have multiplied to fill the gap thus left in the national economy. They accumulate capital by selling their shares across the country, and gather together the invested monies of their shareholders for the express purpose of providing funds to satisfy the need for long-term real estate mortgage loans, in their own jurisdictions and in other states. The investments are designated as shares of capital, under one term or another, because that is characteristic of the relationship desired and created by the investment contract. In virtually every jurisdiction, the investment is subject to withdrawal from time to time, if, and only if, the associations have funds available in excess of their currently owing cash commitments for the purpose for which they were founded. On December 31, 1965, of the total of almost \$129.5 billion of assets of savings and loan associations in the United States, 85% was invested in such mortgages. (An. Rep. Dec. 31, 1965, Fed. Home Loan Bank Board, Washington, D. C., p. 133.)

8. Payment would be subject to the conditions of § 773.

or of the dividends which, pursuant to the By-Laws, had not been credited directly to the account but had been credited to "[un]divided profits" of the Association (§§ 710(t), 778(d)).

4. Management of CSA's Affairs and Rights of Shareholders.

Every capital account, however purchased, was required by the Illinois Act to be evidenced by one or more appropriate certificates, and either such certificates or an account book or both were required to be delivered to the holder of the shares or share account (§ 768(a)). These shares and share accounts were personal property in the hands of the holders (§ 761) and were expressly made transferable by written assignment accompanied by delivery (§ 768(b)).

Under the Illinois Act, CSA's business and affairs were to be managed by its board of directors (§ 744(f)), which elected its officers (§ 746(a)). The board of directors was elected annually for one year terms (§ 744(b)) by vote of the persons holding capital shares or share accounts and by borrowers; the Illinois Act gave persons holding such shares or share accounts the vote of one share for each \$100 and for any fraction of \$100 of the aggregate withdrawal value of their accounts (§ 742(d)(2)), and gave each borrower one vote in addition to any vote he may otherwise have had (§ 742(d)(4)). The provisions for voting either in person or by proxy (§§ 742(c), 744(b)) were identical with those in the Illinois Business Corporation Act (Ill. Rev. Stat., Ch. 32, § 157.28 (1963)). Shareholders could attend annual meetings (§ 743); and in addition to voting for directors could pass on organic changes, such as amendments of the articles of incorporation (§ 812), mergers (§ 816), sales of all or substantially all assets (§ 821), reorganizations (§ 872) and voluntary liquida-

tions (§ 902); upon dissolution or liquidation they would receive their prorata share of the property of the Association after payment of its debts (§§ 908, 926). The shareholder's capacity to acquire the information necessary to solicit proxies effectively or to cast his vote knowledgeably as to these matters, however, was limited by the statutory restriction on his access to the books and records of CSA. A shareholder had the right to inspect only such books and records of the association as pertained to his account (§ 748).

Investments.

The management of CSA could borrow money for the use of the Association (§ 707). It could invest CSA's capital in loans on the security of its own shares or of real estate virtually without restriction, no limitations being set in the Illinois Act as to the kind or speculative nature of improvements to be financed by the loans (§ 791).⁹

9. The record here discloses the nature and type of the ventures in which CSA's directors invested the capital committed to them by the shareholders. It also demonstrates the reason for CSA's insolvency. These disclosures are contained in the Peat, Marwick, Mitchell & Co. Special Report (hereinafter "The Report"), which is part of the Record here, a summary of same being printed in the transcript (R. 40-42). That Report, prepared for the Department of Financial Institutions of the State of Illinois and submitted to its Director, respondent Knight, on June 15, 1964, purported to reflect CSA's financial position as of April 30, 1964. Within eleven days after receipt of this Report, CSA was seized by respondent Knight under the authority of § 848 of the Illinois Act.

The Report reveals the following:

1. \$31,475,499.00 of CSA's total assets of \$34,486,264.00 were invested in first mortgage loans (Ex. A to The Report).

2. \$25,814,435.00, or 82% of CSA's total portfolio of such loans went to the development of two real estate subdivisions known as Apple Orchard, Bartlett, Illinois, and Howie in the Hills, Hoffman Estates, Illinois (R. 41; The Report, p. 5). The funds made available for this purpose by CSA were for land purchases, subdividing, development of land, and construction of buildings (The Report, p. 8). Since the time these developments had been started, CSA financed and refinanced the same properties to the extent of

Under certain conditions (§ 792), the management could invest more than 45% of the Association's total assets as follows: certain marketable investment securities (15%) (§ 792.8), the initial purchase and development of residential properties (10%) (§ 792.7), direct general obligations of certain political subdivisions (15%) (§ 792.6), obligations of urban renewal investment corporations (5%) (§ 792.10) and other investments (§§ 792.1-792.5, 792.9).

Dividends.

Share and share account holders were entitled to dividends when and if declared (§ 762(b)) through which they participated in the profits of the Association (§§ 778, 779, 780). CSA was required to apportion profits and losses at least annually and was empowered to declare dividends out of profits after each apportionment (§§ 778(c), 760),

\$64,250,000.00 (R. 42). The intimate connection and financial interest of present and past officers and directors of CSA with the promotion and construction of these developments is shown in Schedule 2 and Appendix C to the Report.

3. Included in loans to these two developments were the sums of \$959,336.00 and \$806,790.00 for two golf courses, \$241,674.00 for farm and riding stables, \$1,958,522.00 for a country club subdivision, and \$5,267,174.00 for a shopping center (The Report, pp. 6, 7).

4. The book value of the loans in connection with these two developments exceeded current test appraisals of the properties involved by \$14,110,711.00, thus impairing CSA's assets to that extent, at least (The Report, pp. 4, 11).

Under these circumstances it is difficult to explain why supposedly responsible officials of the Department of Financial Institutions of the State of Illinois, within a month after seizure of that institution by them, approved a plan of purportedly voluntary liquidation purportedly voted by the shareholders on July 28, 1964 (R. 44), particularly since custody of a seized savings and loan institution is to be relinquished only where the Director finds that the causes for taking custody have been removed (§854). Absent such finding, which could not occur here because of the magnitude of the impairment of CSA's capital, it was mandatory that a receiver be appointed by defendant Knight and that on his initiative the liquidation proceed only under court supervision (§§ 921-923).

5. The Amended Complaint Alleges Material Frauds.

Material Adverse Information Concerning CSA's Dominant Director and Principal Executive Officer Was Concealed.

At all relevant times, the board of directors of CSA, its policies and activities were dominated and controlled by defendant C. Oran Mensik. From about 1943 until filing of this action, Mensik was CSA's principal executive officer (R. 6).

Beginning in 1957, Mensik became the subject of a substantial flow of adverse publicity in which he was accused, among many other things, of certain specified misconduct as a director and officer of CSA in breach of his fiduciary duties, and of mismanagement (R. 6-8). In 1959, he was indicted in the U. S. District Court in Maryland on mail fraud charges involving savings and loan associations, and was ultimately convicted (R. 8).

Because Mensik's name, thereafter, was not likely to engender trust and confidence in the minds of prospective CSA shareholders, Mensik and the other directors and officers of CSA in 1959 and continuously thereafter conspired to and did conceal from the investing public, including petitioners, that Mensik was in any way connected with CSA as a director or officer. Such concealment constituted the omission of material facts, the disclosure of which would have caused investors to refrain from investing in the shares which CSA was constantly issuing (R. 8, 9).

CSA's Financial Strength Was Misrepresented.

CSA solicited investments in its shares by sales literature mailed to investors in many states of the United States. That literature spoke of the financial strength of CSA and advanced reasons as to the desirability of investing in its shares. However, because CSA's financial

policies and management were found to be unsafe, the Federal Home Loan Bank Board had rejected CSA's application for insurance of its shareholders' accounts, thus refusing the insurance customarily provided by that Agency to shareholders of both federal and state chartered savings and loan associations, leaving such accounts uninsured. CSA's sales literature did not disclose such rejection, the reason therefor, or any of such facts. Included in such mail solicitation, among others, were investors in federally insured savings and loan associations, who in reliance upon such solicitations liquidated such investments and reinvested in CSA shares, thereupon becoming uninsured because of the above-stated non-disclosures (R. 9, 10).

CSA Concealed the Withdrawal Restrictions It Had Imposed Because of Its Financial Difficulties.

Beginning in 1957, CSA was in difficulties because its cash commitments far exceeded its cash resources, and it therefore imposed restrictions on withdrawals by investors. A 1959 amendment to the Illinois Act, under such circumstances permitted sales of new investments but prohibited CSA from placing withdrawal restrictions thereon. Nevertheless, after July 23, 1959, CSA contracted to sell restricted withdrawal shares to investors, including petitioners, without disclosing to them that such sales were unlawful, that CSA was on a restricted withdrawal basis, or that it had financial difficulties requiring such restrictions (R. 10, 11).

6. Respondents' Motions to Dismiss.

Insofar as here pertinent, respondents moved to dismiss the Complaint on the ground that Section 10(b) of the 1934 Act does not apply to fraudulent sales of withdrawable capital shares of savings and loan associations (R. 15-17).

7. The District Court Sustained the Complaint and Was Reversed Below.

The District Court denied respondents' motions and held that petitioners had entered into "an investment contract and in effect are purchasers of securities within the meaning and provisions of the Exchange Act" (R. 17, 32). It certified its order for interlocutory appeal, pursuant to 28 U. S. C. § 1292(b) (R. 32). The United States Court of Appeals for the 7th Circuit reversed this order in a 2-1 decision, Judge Cummings dissenting.

SUMMARY OF ARGUMENT

This Court has established that the definitions of a security set forth in Section 3(a)(10) of the Securities Exchange Act of 1934 are designed to cover the many schemes devised by those who seek the use of other people's money by promises of profit. Accordingly, this Court has held that the question as to whether or not a particular interest is a security is to be decided flexibly rather than on narrow principles and always with a view towards whether or not such interests either on their face answer the description of a security or are dealt in under terms and courses of dealings which establish them as such.

The application of these principles to the capital shares and share accounts sold by an Illinois savings and loan association requires a determination that such interests are securities within the purview of the 1934 Act because of their basic and material characteristics and attributes under the Illinois Savings and Loan Act. Such characteristics and attributes include those which relate to the risk of investment taken by the purchasers of such interests and to their rights to participate in the selection of management and to share in the profits, if any, by way of dividends. Those characteristics stamp the interest here as "stock", "transferable share", "certificate of interest in a profit-sharing agreement" and "investment contract".

These interests also fall within the catch-all clause of the definition, "commonly known as a 'security'", because the substance of the investment relationship of the interests here involved is that of investments commonly known as a "security", and because of the following additional reasons:

1. The State of Illinois and other States have many times specifically referred to these interests as "securities" in a number of statutes covering legal investments. In addition the Illinois Securities Act itself speaks of these as "securities".

2. The savings and loan industry recognizes these to be "securities" and has so recognized them even prior to passage of the Securities Act of 1933.

3. The federal agency in charge of administration of the Securities Exchange Act of 1934 has consistently regarded these interests as "securities" from 1934 to the present time.

The Court below, in deciding that capital shares and capital accounts of Illinois savings and loan associations were not securities within the definition of the 1934 Act, failed to heed the *caveats* of this Court as to the liberal construction to be given definitions in such remedial Acts. It ignored all the basic and material characteristics which established these interests as securities, apart from brief passing reference thereto, and accorded them no weight whatsoever. Instead, it preoccupied itself with and relied on relationships which do not exist under the Illinois Act between the owner of a capital share or share account of an Illinois savings and loan association and the association, and also on characteristics which were entirely immaterial to the question before it. Thus, among other erroneous findings, the Court below held the transactions here under scrutiny to be loans repayable at interest at the will of the lender, despite the plain provisions of the Illinois Act and the decision of the Illinois Supreme Court that such debtor-creditor relationship is neither permitted by the Illinois Act nor otherwise legal.

ARGUMENT¹⁰

I.

Withdrawable Capital Shares in a Savings and Loan Association Are "Securities" Within the Meaning of the Securities Exchange Act of 1934 Since They Possess the Material Characteristics of a "Stock", "Certificate of Interest in a Profit-Sharing Agreement", "Transferable Share" and "Investment Contract".

The federal securities legislation is to be construed "not technically and restrictively, but rather flexibly to effectuate its remedial purposes." *Securities and Exchange Commission v. Capital Gains Research Bureau, Inc.*, 375 U. S. 180, 195 (1963). Particularly, the definition of a security "embodies a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." *Securities and Exchange Commission v. W. J. Howey Co.*, 328 U. S. 293, 299 (1946).

The entire capital of CSA, an Illinois corporation operating as a mutual savings and loan association, is "represented by withdrawable capital accounts (shares and share

10. The dissenting opinion of Judge Cummings in the Court below in itself constitutes a complete and impeccable argument in support of petitioners' contentions and effectively refutes and rebuts each point made in the majority opinion below. This Court's attention in this connection is respectfully directed to the authorities relied on by Judge Cummings and his reasoning in connection therewith.

accounts)".¹¹ As heretofore shown in the Statement, the Illinois Act provides, among other things, that such shares are transferable (§§ 761, 768) and shall be evidenced by certificates (§ 768); that the shareholders participate in net profits through dividends, when and only if earned, and only if declared by the directors (§§ 762, 778, 780); that shareholders may attend annual meetings (§ 743), vote for directors (§§ 742, 744), pass on organic changes, such as amendments of the articles of incorporation (§ 812), mergers (§ 816), sales of all or substantially all assets (§ 821), reorganizations (§ 872) and voluntary liquidations (§ 902); and upon dissolution or liquidation the shareholders are to receive their respective pro-rata shares of the property of the association after payment of its debts (§§ 908, 926).

Thus by virtue of express terms in the 1934 Act definition, a withdrawable share or share account, created and so endowed under the Illinois Act, is "stock" and a "transferable share"; the certificate which is required to be delivered to the shareholder is a "certificate of interest or participation in any profit-sharing agreement" and the contract entered into between the association and each investor is an "investment contract", all within the meaning of the definition of "security" in Section 3(a)(10) of the Securities Exchange Act of 1934 (hereinafter "the 1934 Act").

11. § 761(a). These interests are identified variously and interchangeably by the Illinois statute which created them as shares, share accounts, withdrawable capital accounts, matured shares, share interests, share accounts, withdrawable capital, accounts, withdrawable shares, capital, capital accounts, withdrawable share accounts, and holdings of "shareholders". Ill. Rev. Stats., C. 32, §§ 701-944. Such use of these terms interchangeably is entirely consistent. All of them derive from § 761(a) which identifies the "capital of an association" (aside from permanent reserve shares which are not pertinent here) as "withdrawable capital accounts", and identifies those as synonymous with "shares and share accounts."

In construing the substantially similar definition of a security under the Securities Act of 1933 (15 U. S. C. § 77b (1)) (hereinafter "the 1933 Act"),¹² in *Securities and Exchange Commission v. C. M. Joiner Leasing Corporation*, 320 U. S. 344 (1943), this Court described the terms "transferable share" and "investment contract", as well as the clause "in general any interest or instrument commonly known as a security", as being of "variable character" and said at 351:

"We cannot read out of the statute these general descriptive designations merely because more specific ones have been used to reach some kinds of documents. Instruments may be included within any of these definitions, as a matter of law, if on their face they answer to the name or description. However, the reach of the Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as 'investment contracts', or as 'any interest or instrument commonly known as a security'."

That the interest involved here is a "transferable share" of an interest in the assets of CSA is immediately self-

12. The majority opinion summarily rejects petitioners' citation of cases interpreting "security" in the substantially identical definition in the Securities Act of 1933 (R. 49, 50), on the theory that the term "evidence of indebtedness" found there was omitted from the 1934 Act definition. This is irrelevant because the interests before this Court are not evidences of indebtedness since, as hereinafter shown in the Argument, they do not involve a debtor-creditor relationship. Further, nothing in the Congressional hearings on the 1933 or 1934 Act or elsewhere supports the conclusion that evidences of indebtedness, other than long term notes, bonds and debentures, were intended to be excluded from the 1934 Act definition of "security". Its only expressed exclusion was certain short term commercial paper described as those notes, drafts and bills of exchange with a maturity not exceeding nine months. Even such items with a longer maturity would not be excluded.

evident: "All shares and capital accounts shall be personal property in the hands of their holders, transferable as provided in this Act. . . ." (§ 761(b) and § 768(b)).

The characteristics of this interest also clearly stamp it as "stock". The Illinois Supreme Court, in *Bowman v. Armour & Co.*, 17 Ill. 2d 43, at 51, 160 N. E. 2d 753, 757 (1959) defined a share of stock as follows:

"A share of stock in a corporation is a unit of interest in the corporation and it entitles the shareholder to an aliquot part of the property or its proceeds to the extent indicated. The interest of a shareholder entitles him to participate in the net profits in proportion to the number of his shares, to have a voice in the selection of the corporate officers and, upon dissolution or liquidation, to receive his portion of the property of the corporation that may remain after payment of its debts."

The capital shares of petitioners possess each of these characteristics set out by the Illinois Supreme Court. In *Gidwitz v. Lanzit Corrugated Box Company*, 20 Ill. 2d 208, 215; 170 N. E. 2d 131, 135 (1960), the Illinois Supreme Court was even more specific:

"The essential attribute of a shareholder in a corporation is that he is entitled to participate, according to the amount of his stock in the selection of management of the corporation, and he cannot be deprived or deprive himself of that power."

Under §§ 742, 744 and 746, a shareholder in a savings and loan association is entitled to participate in the selection of management, in proportion to his interest in the association.¹³

13. Illinois courts have consistently considered the holder of this type of interest to be a "stockholder" and "shareholder". *People v. Logan County Building & Loan Association*, 369 Ill. 518 (1938) at 528: "The insolvency of a building and loan association is recognized as *sui generis*. It may be described as a condition which reduces the available and collectible assets below the level

The withdrawable capital shares here also constitute an "investment contract", which was defined in *Securities and Exchange Commission v. W. J. Howey Co.*, 328 U. S. 293 (1946), where this Court stated at pages 298-99:

"... an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party, it being immaterial whether the shares in the enterprise are evidenced by formal certificates or by nominal interests in the physical assets employed in the enterprise."

The shareholders in this savings and loan association have provided all of its capital (§ 761(a)), are the only persons entitled to share in its profits (§§ 762, 778) and may have surrendered even residual annual control of their common investment by execution of long term proxies which the majority opinion incorrectly described as irrevocable proxies (R. 47). In Illinois, irrevocable proxies are void as against public policy. *Luthy v. Ream*, 270 Ill. 170 (1915); *Laughlin v. Johnson*, 230 Ill. App. 25 (1923). A proxy form employed by the management of CSA recites that "unless revoked" the proxy is to operate while shareholder continues as such, and "if revoked" revocation applies only to meeting for or at which "right to revoke" is exercised (R. 35).

As heretofore seen, purchasers of these shares are referred to as "holders" (§ 773), the shares are required by statute to be "evidenced by one or more . . . certificates"

of the stock already paid in, thereby rendering it impossible for the association to pay back its stockholders the amount of their contributions." *Marshall Savings and Loan Association v. Henson*, 78 Ill. App. 2d 14, 222 N. E. 2d 255 (1966) at 261: "It is undisputed that the Illinois Savings and Loan Act gives the depositors the status of shareholders by conferring one vote for each \$100 on deposit and that under this formula the depositors own the majority of the voting rights."

(§ 768(a)), and are transferable by assignment (§ 768(b)). The capital derived by the association through sales of its shares, is invested by the management of the association at the risk of investors, so that if management fails to produce a profit the investors suffer the loss (§§ 778, 780, 781).

CSA, like other similar associations, vigorously solicited the entire public to invest savings in its capital shares¹⁴ and then reinvested the resulting and often small individual investments in, *inter alia*, real estate mortgages, municipal securities and other "marketable investment securities" (§§ 791, 792). CSA's investments were selected and made by decision solely of CSA's board of directors and officers. If those investments turned out to be unwise or unsound, petitioners and other CSA capital shareholders stood to lose their investments—in many cases, the savings of a lifetime. (As to how CSA invested its shareholders' capital and the consequences to them, see footnote 9, p. 10, *supra*.) The investment risk was theirs alone, a critical factor, as observed by Mr. Justice Brennan in *Securities and Exchange Commission v. Variable Annuity Life Insurance Company*, 359 U. S. 65, 77-80 (1959).

The lower Court was persuaded to find the shares in this savings and loan association not to be securities because, among other reasons: (1) the investor "lends his money to be withdrawable at will and to earn interest" (R. 48), (2) "the relationship with the enterprise is much more that of debtor-creditor than investment" (R. 48) and, (3) like mutual insurance companies "the local state authorities are ready and willing to handle the orderly disposition of the institution's liquidation" (R. 51). The first two statements of the Court below are in error and are unsupported by any authority, nor could they be in the face of the ex-

14. See Exhibits B, C and D to Supplementary Affidavit of George L. Weisbard printed in summary in the Record (R. 38-40). The Exhibits have not been printed.

press provisions of the Illinois Act. Those statements indicate that the Court below failed to comprehend or analyze the true nature of the transactions here involved and developed a confused approach to them. Thus, in one place that Court speaks of such transactions as loans (R. 48) and in another as "deposits" (R. 44, 45). There are, of course, material distinctions between loans and deposits. *Gorham v. Hodge*, 6 Ill. 2d 31, 38, 39 (1955). In any event, the transactions here could be neither loans nor deposits under the Illinois Act for several reasons.

In the first place, the investor does not *lend* his money to be withdrawable at will and to earn interest. The transactions permitted by the Illinois Statute are completely different from loans because: (a) the investor has a right to a voice in management, (b) he bears the primary risk of the business venture and could conceivably lose all or part of his investment, (c) no interest is paid, (d) he stands to profit only by way of dividends if earned by the venture and if declared, and (e) there is no obligation on the part of the association to seek him out and pay him until his shares, under certain plans permitted by the Act, have reached, if ever, an agreed maturity value by reason of installment payments and the accretion of dividends.

Secondly, the transactions cannot be viewed as deposits giving rise to debtor-creditor relationships. The Supreme Court of Illinois has so held. *Gorham v. Hodge*, 6 Ill. 2d 31, 41 (1955). In addition, the Illinois Act provides that "No association to which this Act applies shall accept or carry any demand, commercial or checking account." (§ 709(a)), and that "the holder of withdrawable capital for which application for withdrawal has been made *does not become a creditor*" (§ 773(f)). (Emphasis supplied.) Obviously, if even application for withdrawal does

not cause him to "become a creditor", the Illinois Act intended that the holder of withdrawable capital not be a creditor.

Much of the reasoning of the court below in the above connection seems to be based on its view that the capital shares of savings and loan associations are withdrawable at will. In the case at bar, the Complaint specifically alleges that CSA's shares purchased by petitioners were not so withdrawable¹⁵ but even that fact is immaterial since withdrawability has a unique meaning in the context of savings and loan associations¹⁶ and in any event does not affect the quality of a "security".¹⁷ Subsequent to the lower court decision in this case, this Court decided *Securities and Exchange Commission v. United Benefit Life Insurance Company*, 18 L. ed. 2d 673 (1967), wherein it held a "Flexible Fund Annuity" to be a security despite or because of the fact that "the purchaser, at all times before maturity, is entitled to his proportionate share of the total fund and may withdraw all or part of this interest." 18 L. ed. 2d 676.

15. The capital shares purchased by the petitioners in this case were sold on a restricted withdrawal basis, as alleged in paragraph 21 of the Complaint (R. 10-11), which allegation must be treated as true at this stage of these proceedings. *Radovich v. National Football League*, 352 U. S. 445, 448 (1957); *Guessefeldt v. McGrath*, 342 U. S. 308, 310 (1952); *United States v. New Wrinkle*, 342 U. S. 371, 376 (1952); and *Collins v. Hardyman*, 341 U. S. 651, 652 (1951).

16. "The right of a shareholder to surrender his shares and receive the withdrawal value thereof is a peculiar feature of associations of this character. . . . Withdrawal of stock is but the mode of apportioning to a withdrawing member his share of the assets of the corporation before his stock has reached maturity value . . ." *Young v. Stevenson*, 180 Ill. 608, 613 (1899). See also, 13 Am. Jur. 2d, *Building and Loan Associations*, § 30, at pages 170-1.

17. In some cases a similar right of withdrawal has been agreed upon with regard to corporate stock and held to be enforceable where the rights of creditors would not be prejudiced. *In re Tichenor-Grand Co.*, 203 F. 720 (S. D. N. Y. 1913), citing *Ophir Consolidated Mines v. Brynteson*, 143 F. 829 (7th Cir. 1906).

The refusal of the Court below to consider the vital characteristics above described which bring the interests here involved within a number of the categories of securities defined in the 1934 Act and its preoccupation with other characteristics which are either misunderstood, misstated or immaterial to the question has led it, as above shown, into serious error and conflict with decisions of this Court. That error, unfortunately, is compounded by the attempt of the Court below to analogize ordinary mutual insurance policies with the interests here under scrutiny. In so doing, it reasoned that these interests are not securities because they may be compared to ordinary insurance policies which are not securities because they are not traded like stock and are State regulated so as to protect policyholders from wrongdoing (R. 50, 51).

That reasoning is fallacious on a number of counts. Firstly, even if the interests here were at all comparable to insurance policies, *Securities and Exchange Commission v. Variable Annuity Life Insurance Co. (VALIC)*, 359 U. S. 65 (1959) and *Securities and Exchange Commission v. United Benefit Life Insurance Company*, 18 L. ed. 2d 673 (1967), do not permit the analogy. Those decisions make clear that when insurance contracts involve considerations of investment and characteristics not present in ordinary insurance policies, i.e., the placing of the investment risk on the policyholder, they are securities within the definition of the 1933 Act. Such characteristics are, of course, the *sine qua non* of petitioners' interests here. Secondly, both of these cases, as well as many others, indicate that it is elementary that trading as a stock is immaterial to whether or not a particular interest is a security under both the 1933 and 1934 Acts. Finally, the reference by the Court below to the alleged fact that the Illinois State authorities are ready, willing and able to handle the orderly disposition of CSA's liquidation (R. 51), as if such readi-

ness could prevent wrongdoing, is aimless and involves a *non sequitur*. The Court below does not state how under the Illinois Act supervision under a voluntary plan of liquidation (or even under an involuntary liquidation) could possibly protect investors from the fraud which induced their purchases of share interests in CSA years before. As a matter of fact, there is nothing in the Illinois Act which affords protection to investors in savings and loan associations after they have been fleeced.¹⁸

The question of concurrent state regulation is not in this case at all. Even if it were, such regulation is immaterial as is made evident by this Court in *United Benefit Life Insurance Company*, wherein it quotes a Court of Appeal's analysis of the earlier case of *VALIC* with approval as follows at 18 L. ed. 2d 673, 679:

"The argument 'that the existence of adequate state regulation was the basis for the exemption (the position taken by four dissenting Justices) . . . was conclusively rejected . . . in *VALIC* for the reason that variable annuities are "securities" and involve considerations of investment not present in the conventional contract of insurance.' *Prudential Insurance Co. v. S. E. C.*, 3 Cir., 326 F. 2d 383, 388."

Mr. Justice Brennan in his concurring opinion in *VALIC* (joined by Mr. Justice Stewart) said at 359 U. S. 65, 75:

"Concurrent regulation . . . was contemplated by the Acts as a quite generally prevailing matter. Nor is it rational to assume that Congress thought that *any* business whatsoever regulated by a specific class of officials . . . would be for that reason so perfectly conducted and regulated that all the protections of

18. In the case at bar, it either took the Illinois authorities a number of years to discover that most of CSA's capital had been invested in mortgage loans on properties, the appraisal values of which had been grossly overstated, or else they just condoned such false valuations.

the Federal Acts would be unnecessary. This approach of personally selected deference to the state administrators is hardly to be attributed to Congress."

In conclusion on this section of the argument, it is pointed out that the oil leases in *Joiner*, the citrus grove units in *Howey*, the variable annuities in *Variable Annuity*, the flexible annuities in *United Benefit* have been held by this Court to be "securities," and interests in fishing boats, automobile trailers, vending machines, parking meters, cemetery lots, tung trees, vineyards, fig orchards, farm lands and patent rights have been held to be "securities" in decisions of lower federal courts. See *e.g.*, 1 Loss, Securities Regulation (2 ed. 1961), pp. 490-91 and 1962 Supplement p. 30 (App. 34). So here, the attributes of petitioners' capital shares in CSA established their character in commerce as securities subject to the 1934 Act.

The primary aim and purpose of both the 1933 and the 1934 Act is the protection of the general public and investors, including uninformed, gullible, ignorant and little investors. *Surowitz v. Hilton Hotels Corporation*, 383 U. S. 363 (1966). Judge Cummings set forth how the aims and purposes of the 1934 Act are served by the application of that Act "to the typical savings and loan account-holder (who) is a small investor, as unwary and in need of protection as a typical, unsophisticated holder of corporate stock" (R. 63).

II.

Withdrawable Capital Shares in a Savings and Loan Association Are "Instruments Commonly Known as a 'Security'" and Are Therefore Within the Ambit of the Securities Exchange Act of 1934.

It has been demonstrated hereinabove that under the Illinois Act the substance of the investment relationship involved in the interests here under consideration is not that of an evidence of indebtedness because no debtor-creditor relationship existed; that in keeping with the ruling of the Illinois Supreme Court in *Gorham v. Hodge*, 6 Ill. 2d 31, 41, a savings and loan association chartered and operating under the Illinois Act could not have accepted such investments under a debtor-creditor relationship; and that the lower Court erred in rejecting out of hand from consideration here the decisions of this Court interpreting "security" under the definition in the Securities Act of 1933 (R. 52), for the declared but erroneous as well as irrelevant reason that the investors here loaned their money at interest and their investments were therefore "evidences of indebtedness" (R. 48-50).

It has been further demonstrated hereinabove that the investment interests here under consideration fall within at least four of the categories of the 1934 Act definition, i.e., "stock", "transferable share", "investment contract", and "certificate of interest or participation in any profit sharing agreement". It is demonstrable, contrary to the lower Court's opinion, that these interests also fall within the catch-all clause of the definition, "or in general any instrument commonly known as a 'security'".

To what sources are we to look in ascertaining whether the interests here are "commonly known as a 'security'"? The lower Court points to the Congressional hearings on

the 1933 Act (R. 50), the House Report accompanying that Act (R. 47), the preamble to the 1934 Act (R. 47), and to the action of the Illinois legislature in adopting the Illinois Act (R. 47).

In noting that the Illinois Act (§ 768(c)) provides that these certificates and account books shall not be subject to Article 8 of the Uniform Commercial Code, which deals solely with negotiable "securities", the Court below concludes therefrom "that the Illinois legislature did not intend them to be securities", and that "It thus seems difficult to assert that these interests can be 'commonly known as a security.'" (R. 47.) The lower Court fails to recognize that in excluding these interests from applicability of an article of the Commercial Code which deals solely with those *securities* which are to have the attribute of negotiability, the very necessity of the exclusion discloses that the legislature considered these interests to be securities. There is a broad gap between the expressed intention of the legislature that these interests are not to be subject to an Act which deals solely with negotiability and the unwarranted conclusion drawn therefrom by the lower Court that the legislature intended that they not be considered securities for any purpose. The lower Court fails to explain how it bridged that gap. There are a variety of reasons why its conclusion is erroneous.

Most obvious is the fact that § 768(c) provides that these interests shall be "non-negotiable", and it was therefore necessary for the same section to provide that such non-negotiable interests should not be subject to the article of the Commercial Code which deals only with negotiable securities. Had the legislature intended by the language of § 768(c) to exclude these interests from being subject to the Illinois Securities Law of 1953, Ill. Rev. Stat., 1965, ch. 121½, § 137 *et seq.*, it could have done so with the same

specificity as it used in stating their exclusion from Article 8 of the Commercial Code.

The lower Court obviously failed to note the official Illinois Code comment to ch. 26, § 8-102 of the Code, defining "security" for the limited purposes of that Article. This comment specifically recognizes that the definition of security contained in Article 8 of the Code is a narrower definition, for the purposes of that article only, while,

"Securities are broadly defined in the Illinois Securities Law of 1953, the Securities Act of 1933 and the Securities Exchange Act of 1934 for regulatory purposes." Illinois Code Comment, S. H. A., ch. 26, Section 8-102.

Thus it has been officially recognized that coverage under the regulatory Illinois Securities Law of 1953 is far wider than coverage under Article 8 of the Illinois Commercial Code.

Under that Securities Law the Illinois legislature expressly recognized by designation that the withdrawable capital share and share account are securities and specifically provided an exemption for them, but only from those of its provisions pertaining to registration. That Act states:

"The provisions of Sections 5 and 7 of this Act shall not apply to any of the following *securities*: . . .

D. *Securities* issued by and representing an interest in or an obligation of, (1) any building and loan association incorporated under the laws of the state, (2) any Federal Savings and Loan Association, (3) any savings and loan association incorporated under the laws of any state if such association is a member or stockholder of the Federal Savings and Loan Insurance Corporation, or (4) any credit union approved and supervised by the Auditor of Public Accounts; . . ." (Ill. Rev. Stat., 1965, ch. 121½, 137.3.) (Emphasis added.)

Such an exemption of savings and loan shares has existed continuously since prior to the time it first became possible in 1953 for an Illinois savings and loan association to issue permanent reserve shares (a type of share other than withdrawable capital shares and not involved here). (Ill. Rev. Stat. 1951, ch. 121½, § 99A (2).)

The Illinois legislature by exempting such withdrawable capital shares and share accounts from registration only, has thereby also indicated its determination that these interests, which it designates as securities, should be subject to all provisions of the Illinois Securities Act other than §§ 5 and 7 thereof, the registration provisions.¹⁹

The conclusion inevitably follows that these interests are "commonly known" to the Illinois legislature as securities both by designation and by essential substance, otherwise there would have been no necessity for the legislature to exclude them from the negotiability section of the Commercial Code and from the registration provisions of the Illinois Securities Act of 1953. But this conclusion that the legislature regards these interests as "securities" does

19. The existence of a concurrent remedy or of concurrent supervision under the Illinois Blue Sky law is not claimed by anyone to render void similar provisions in federal securities laws. As to any question of whether State supervision of operations of savings and loan associations has any bearing on applicability of the anti-fraud provisions of the federal securities laws to withdrawable shares, it is to be noted that the kind of State supervision or regulation under the Illinois Act does not touch on the area of issuance of shares and share accounts. The basic right to issue them is fixed by statute, and the situation is unlike the State regulation of issuance of contracts of insurance, which must be approved as to each form of contract by a State Administrative Agency. Ill. Rev. Stat. 1965, ch. 73, § 755. As to savings and loan associations, State regulation under the Illinois Act has nothing to do with the kind of problems involved in the anti-fraud provisions of the 1934 Act and no comparable power is given to State officials under the Illinois Act to control the issuance by an association in good financial standing of shares or share accounts if the plan of issuance is one of those authorized by the Illinois Act.

not rest merely on the foregoing explanation of the legislative attitude toward these interests demonstrated by enactment of § 768(c) of the Illinois Act and by enactment of § 137.3 of the Illinois Securities Act, or on the foregoing explanation of the error committed by the lower Court's unwarranted extension of what is merely a limited and narrow exemption of these interests from the negotiability article of the Commercial Code. The lower Court also overlooked the action of the Illinois legislature in adopting other laws which designate these interests as "securities".

The Investment of Public Funds Act, Ill. Rev. Stat., 1965, ch. 102, § 30, permits any public agency to "invest any public funds in . . . shares or other forms of *securities* legally issuable by savings and loan associations incorporated under the laws of this State or any other state, or under the laws of the United States . . .". (Emphasis added.) This Act was adopted in 1943 at a time when the capital of an Illinois savings and loan association could consist only of the withdrawable type of interest under consideration here.

The State Treasurer Act, Ill. Rev. Stat., 1965, ch. 130, § 41a, permits the investment of State money,

"in shares and investment certificates of savings and building and loan associations, incorporated under the laws of this State or any other state or under the laws of the United States . . .".

and provides that such investments may be made only in those associations whose "*shares or other forms of investment securities*" are federally insured. (Emphasis added.)

The Credit Union Act of Illinois, Ill. Rev. Stat., 1965, ch. 32, § 496.23, provides that a credit union "may invest its funds in any of the following designated *securities*:" (Emphasis added.)

"(2) shares or investment certificates of any savings

... and loan association incorporated under the laws of this State or of any other state or of the United States ...".

Further, the interpretation of the words "commonly known as a security" is not restricted to those investments which may specifically be called "security". A reasonable interpretation necessarily looks to the substance or essential nature of the investment relationship involved. Those investments which by this measure are the substantial equivalent of a "security" must be included under the "commonly known as a security" portion of the definition. The Statement, *supra*, pp. 4-11 includes in ample detail references to sections of the Illinois Act creating the investment relationships involved in the interests here under consideration. The sections there cited establish that these interests are securities within the meaning of the 1934 Act definition.

The Illinois legislature has enacted other Acts by which the shares or accounts of savings and loan associations are declared to be authorized investments. In adopting these Acts, the Illinois legislature was dealing with instruments involving the substance of the type of investment relationships "commonly known as a security", within the meaning of *SEC v. C. M. Joiner Leasing Corporation*, 320 U. S. 344, 351. There it was held that instruments may be included within any of the categories in the 1933 Act definition "as matter of law, if on their face they answer to the name or description . . .". *Joiner* further held, p. 351, "However . . . irregular devices, whatever they appear to be, are also reached [by the definition] if . . . widely offered or dealt in under terms or courses of dealing which established their character in commerce . . . as 'any interest or instrument commonly known as a security'."

The Illinois Insurance Code, Ill. Rev. Stat., 1965, ch. 73,

§ 737.14a, authorizes any domestic insurance company to invest in shares or accounts of savings and loan associations of a withdrawable type, but it may not so invest more than 20% of its admitted assets or more than 2% thereof in any one such association.

Under § 792.1 of the Illinois Act an Illinois savings and loan association may invest part of its available excess funds in withdrawable capital of any other state or federal association which is federally insured.

§ 953 of the Illinois Act provides that any Illinois chartered or federal savings and loan association may issue its shares, share accounts or accounts in the name of any administrator, executor, guardian, trustee or other fiduciary, in trust.

The Illinois Probate Act, Ill. Rev. Stat., 1965, ch. 3, § 259(e) permits guardians or conservators, with approval of Court, to invest in shares of state chartered building and loan associations and in shares of federally chartered savings and loan associations, if federally insured.

An equally fruitful source overlooked by the lower Court in determining whether these interests are commonly known as a security, is the savings and loan industry itself. The report of a study by members of the legal staff of the United States Savings and Loan League published in its Legal Bulletin, Vol. XXVIII, No. 4, July 1962 (pp. 129-234), is highly illuminating. It demonstrates that savings and loan shares and share accounts are "authorized investments" in virtually all states, the District of Columbia and under federal law, and that many times these interests have been referred to in legislation as "securities." The study includes a report on Illinois law and cites various references in Illinois statutes to these interests as "securities".

After extolling the safety and investment advantages of

savings and loan accounts, due to sound, informed and experienced management, with a consistently high return on the investments by the shareholders, the report states at page 136:

"It is a fact that savings and loan accounts are categorized more appropriately as 'legal list' investments than as investments authorized by the 'prudent man' rule in *more variable securities* (such as the shares of sound business corporations). Since the 'legal list' investments are a more limited group the inclusion of savings association accounts in these lists makes automatic their inclusion among those investments available to the prudent man." (Emphasis added.)

Such comparison of savings and loan accounts with "more variable securities" implies that the legal staff of the USSL consider savings and loan accounts as securities.

This conclusion as to the official position of the USSL is supported by the Congressional hearings on the adoption of the Securities Act of 1933. The record discloses that the president of that national organization and its general counsel, as spokesmen for the savings and loan industry, emphatically supported the application of the anti-fraud provisions of that Act to savings and loan shares, even though opposing registration of such interests. (Hearings on H. R. 4314 before the House Committee on Interstate and Foreign Commerce, 73rd Cong., First Sess., pp. 72-74 (1933); Hearings on H. R. 7620 before House Subcommittee of Committee on Banking and Currency, 72nd Cong., First Sess., p. 144 (1932); and Hearings on S. 875 before Senate Committee on Banking and Currency, 73rd Cong., First Sess., pp. 50-54, 98-102, 111-114 (1933).)

The reason urged by these spokesmen in favor of exempting savings and loan shares from the registration provisions of that Act was solely the expense which would be involved. (Hearing on H. R. 4314 before the House Com-

mittee on Interstate and Foreign Commerce, 73rd Cong., First Sess., pp. 70-80 (1933).)

In addition, one of the draftsmen of the 1933 Act, Walter L. Miller, Chief of the Foreign Service Division, Bureau of Foreign and Domestic Commerce, testified that the drafting committee had given careful consideration to coverage of savings and loan shares, including withdrawable capital accounts, and had concluded that the danger of fraudulent practice and promotions by some members of the industry warranted the inclusion of these savings and loan association interests, not only within the anti-fraud provisions of the 1933 Act, but within the registration provisions as well. Indeed, the thrust of Mr. Miller's testimony was that in order adequately to protect investors by means of the 1933 Act, it would be necessary to require registration of savings and loan association interests. (Hearings on H. R. 4314 before the House Committee on Interstate and Foreign Commerce, 73rd Cong., First Sess., p. 74 (1933).)

When the Securities Law of 1933 was enacted, the Secretary of the United States Building and Loan League advised its member associations that they were "subject to the fraud provisions" of that Act, something which would only have been true if he and the League understood shares in such associations to be "securities". See Building and Loan Annals (1933), pp. 564-65. See also Richards, *The Federal Securities Act*, Building and Loan Annals (1933), pp. 111, 115-118.

It is a significant parallel in the federal Securities Act of 1933 and the Illinois Securities Law of 1953 that these interests are exempt only from the registration provisions, leaving them subject to the anti-fraud provisions of both Acts. There is a further parallel in what happened in the adoption of the 1934 Act and the 1964 amendments thereto. When adopted in 1934 that Act contained no registration

provisions and no exemption of the interests here from its anti-fraud provisions. When registration provisions were added by the 1964 amendments, specific exemption of savings and loan association shares was provided from such new registration provisions, but only therefrom. The newly created exemption did not exempt them from the 1934 Act's long standing anti-fraud provisions.

Section 12(g)(2)(c) of the 1934 Act amendments (adopted in 1964), provides:

"(2) The provisions of this subsection shall not apply in respect to . . .

(c) any security other than permanent stock, guarantee stock, permanent reserve stock or any similar certificate evidencing non-withdrawable capital, issued by a savings and loan association, . . . which is supervised and examined by State or Federal authority having supervision over any such institution." 15 U. S. C. § 78l(g)(2)(c).

This reference is enlightening because Congress in the foregoing exemption of withdrawable shares of savings and loan associations specified that instruments representing non-withdrawable capital should not be exempt from these new registration provisions added to the 1934 Act. The new exemption thus covered "any security other than . . . non-withdrawable capital issued by a savings and loan association," and included the withdrawable capital shares and share accounts issued by CSA within the exemption from registration.

The suggestion by the lower Court (R. 49, 50), that the inclusion of the exemption from registration was unnecessary because these interests are not commonly regarded as a security and do not otherwise qualify as such, simply cannot be supported. The same Congress which wrote the Securities Act of 1933 wrote the 1934 Act. If an excess of caution was exercised by Congress in 1933, as suggested

in the majority opinion below, why would not the same Congress have done likewise in 1934.

It is also to be noted, as pointed out by Judge Cummings in his dissenting opinion, that the Securities and Exchange Commission has interpreted the Act as requiring registration of brokers who specialize in the sale of savings and loan shares (R. 62). In its Brief in support of the Petition for Certiorari here the Commission noted that in 1934 a temporary exemption was granted by it for trading in savings and loan passbooks on the Cleveland stock exchange (p. 9). Further in the case of *Archer et al. v. S. E. C.*, 133 F. 2d 795 (8 Cir. 1943), discussed at pages 12 and 13 of Petitioners' Reply to Briefs in Opposition to the Petition for Writ of Certiorari, the decision, at p. 801, discloses that certain certificates issued by a savings and loan association were there involved in misconduct by brokers in violation of the 1934 Act, and in violation of a rule thereunder. The decision indicates that the certificates were traded over-the-counter and that the price fluctuated widely, was manipulated, and that the improprieties constituted a violation of a section of the 1934 Act involving a "security". The source of information that the precise investment interests there involved were withdrawable capital is stated in footnote 17 at page 13 of that Reply Brief.

The reference in the lower Court's opinion to the Congressional Hearings as support for the statement that some Senators evidently saw a relationship between these interests and evidences of indebtedness is simply not supportable by anything in the record of those hearings on the 1933 Act. Further there is nothing in the House Report, or in the preamble to the 1934 Act, referred to at R. 47, which in any way supports the findings of the lower Court that these interests were not then commonly known as securities or that there was ever any intention that savings

and loan shares and share accounts be excluded from the anti-fraud provisions of either the 1933 or 1934 Act. The inclusion in the preamble of reference to immediate events which precipitated passage of the 1934 Act cannot be construed as a limitation on the clear and precise language of the 1934 Act definition, which includes the investment interests involved here within at least five of the designated categories of "security" in that definition.

The majority opinion below makes scant reference to the Congressional hearings on the 1934 Act, apparently being satisfied that there was no discussion of savings and loan interests at that time (R. 50). Although at the same page the Court comments on the "evidence of indebtedness" aspect of the hearings on the 1933 Act, and further cites the Report accompanying that Act (R. 47), no reference is made in that opinion to the Report of the Senate Committee on Banking and Currency as to the 1934 Act. In order to understand the purposes of that Act, it is necessary to note that the Report in its Introductory Statement contains three numbered sets of reasons for its enactment. At the conclusion of that Statement appears the following:

"The three principal problems with which the bill deals are the excessive use of credit for speculation, the unfair practices employed in speculation, and the secrecy surrounding the financial condition of corporations which invite the public to purchase their securities." (Report of Senate Committee on Banking and Currency, 73rd Cong., 2d Sess., No. 792, April 17, 1934, to accompany S. 3420, entitled Federal Securities Exchange Act of 1934, p. 5.)

On policy there appears to be no reason to believe that Congress considered investors in savings and loan shares and accounts to be less needy of the protections against fraud accomplished through non-disclosure and secrecy, than are small investors in other types of securities which the lower

Court would concede to be included within the scope of the Act.

The overriding consideration apparently governing the majority opinion below is the notion that the definition of "security" in the 1934 Act is to be restrictively interpreted. This, of course, is contrary to the rule that remedial statutes are to be liberally interpreted to accomplish their beneficial purposes.

The majority opinion thus devotes its major attention to finding similarities to irrelevant situations and such dissimilarities as it can between the interests here involved and that Court's own idea of the formal or mechanical aspects of a security. As to such of these aspects as it did consider, its conclusions are largely erroneous. But even were it valid to decide the case by reference to mere matters of form rather than substance, the lower Court could not properly ignore, as it did here, the great preponderance of attributes of a security found in these interests, while listing every strained and fancied dissimilarity suggested by respondents.

CONCLUSION.

Petitioners urge that the judgment of the Court of Appeals be reversed.

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IN THE
Supreme Court of the United States

OCTOBER TERM, 1967.

NO. 104

ALEXANDER TCHEREPNIN, MING TCHEREPNIN,
CHARLES NOLL, MAYBELLE NOLL, HARRY
BLOCK, JEANETTE A. BLOCK, WERNER D.
BLOCK, ADRIAN DA PRATO, PETER DA PRATO,
FREDERICK D. WAHL, ANNE W. WAHL, THEO-
DORE MACHATKA, MARIE B. MACHATKA, JO-
SEPH NOVAK, FRANCES NOVAK, MARYBETH
SIMJACK, WALTER R. ANDERSON and HELEN
K. KELLOGG,

Petitioners,

vs.

JOSEPH E. KNIGHT, JUSTIN HULMAN, CITY SAV-
INGS ASSOCIATION, DENNIS KIRBY, HARRY
HARTMAN, LOUIS KWASMAN, ROBERT FRANZ,
STANLEY PASKO, JOSEPH TALARICO, JR., HER-
BERT J. HOOVER, ROBERT M. KRAMER, C. ORAN
MENSIK and GLORIA MENSIK SPRINCZ,

Respondents.

(On Writ of *Certiorari* to the United States Court of
Appeals for the Seventh Circuit)

**BRIEF FOR RESPONDENTS
KNIGHT AND HULMAN**

OPINIONS BELOW

The opinion of the District Court (R. 29) has not been reported. The opinions of the Court of Appeals for the Seventh Circuit (R. 43) are reported at 371 F. 2d 374.

JURISDICTION

The jurisdictional requisites are adequately set forth in the Petitioners' and Securities and Exchange Commission's Briefs.

STATUTES AND REGULATION INVOLVED

The pertinent provisions of the Securities Exchange Act (48 Stat. 881, as amended, 15 U.S.C. 78 a, *et seq.*) are sections 2, 3(a)(10) and 10(b). [15 U.S.C. 78b, 78c(a)(10) and 78j(b)] and Rule 10b-5, the regulation involved (17 C.F.R. § 240, 10b-5) are set forth in the Appendix herein.

QUESTION PRESENTED

Whether a withdrawable capital account in an Illinois-chartered savings and loan association is a "security" within the meaning of that term as it is used in the Securities Exchange Act of 1934?

STATEMENT OF THE CASE

On June 26, 1964, respondent, Joseph E. Knight, Director of Financial Institutions of the State of Illinois, took custody of City Savings Association, an Illinois mutual savings and loan association, pursuant to the authority vested in him as such state officer under Section 7-8, Article 7 of the Illinois Savings and Loan Act

(Ill. Rev. Stat. 1965, ch. 32, par. 848) (R. 44). At that time respondent Justin Hulman was the Supervisor of the Savings and Loan Division of the Department of Financial Institutions.¹

During the time respondent Knight assumed custody of City Savings, petitioners filed the complaint herein on July 24, 1964 (R. 2).

Four days after the filing of the instant action, a special meeting of the City Savings Association shareholders was held for the purpose of approving a voluntary plan of liquidation subject to the approval of respondent Knight. The plan was approved and the liquidators herein were elected, two of whom were and presently are employees of the state of Illinois (R. 3). The association is still in liquidation under state supervision and will remain in liquidation pending the disposition of this case. Section 9-8 of Article 9 of the Illinois Savings and Loan Act (Ill. Rev. Stat. 1965, ch. 32, par. 908) (R. 31-32).

Petitioners allege in their complaint that jurisdiction of the cause is based solely on Section 27 of the Securities Exchange Act of 1934 (15 U.S.C. 78 aa) (R. 2). Petitioners, for themselves and the class they allege they represent for the period from July 23, 1959 until June 26, 1964 (R. 12, Pet. Brief p. 4), aver that they purchased capital shares of and capital account interests of

1. Respondent Justin Hulman presently is the Commissioner of Savings and Loan Associations of the State of Illinois, a state office created by Section 7-1, Article 7 of the Illinois Savings and Loan Act of 1965 (Ill. Rev. Stat. 1965, ch. 32, par. 841) effective August 1, 1965, who assumed the duties of the Director of Financial Institutions, who no longer has any authority over Illinois savings and loan associations (R. 19, 24).

City Savings which had done business at the same address for more than 20 years prior to the institution of this suit (R. 2). Petitioners claim that they were fraudulently induced by various solicitations from City Savings to purchase such accounts thereby constituting a violation of Section 10 (b) of the Securities Exchange Act of 1934. (15 U.S.C. 78 j (b)) and Rule 10b-5 (17 C.F.R. § 240, 10b-5) promulgated thereunder (R. 5). It is alleged that various misstatements, omissions and falsehoods were made in said solicitations by City Savings, among which was the offer to petitioners that in return for a deposit of their money in City Savings they would receive expensive premiums such as TV sets, typewriters, etc. contingent upon the amount of money deposited (R. 9).

Petitioners' sole prayer for relief is to rescind, under Section 29 (b) of the 1934 Act [15 U.S.C. 78 cc (b)] their purchases of such accounts made from the association on the grounds that such purchases were void and to recover the full purchase price paid for the shares of City Savings allegedly fraudulently sold by the association amounting in the aggregate to \$20,000,000 plus interest (R. 6, 13, 14).² No other permanent relief is sought except preliminarily and ancillary to the final judgment, solely from the association and to the detriment of other depositors not within the alleged class.

Respondents herein and respondents City Savings Association and the three liquidators and the defendants connected with the management of the association prior to

2. See Pet. Brief p. 5, footnote 5. The total withdrawable capital of City Savings Association shortly before the seizure by the Department of Financial Institutions of the State of Illinois was \$27,512,110.

the seizure by respondent Knight, in separate motions, moved to dismiss the complaint, *inter alia*, for lack of jurisdiction in the District Court, since jurisdiction was predicated solely on an alleged violation of the Securities Exchange Act (15 U.S.C. 78a *et seq.*) (R. 14-17). The Securities and Exchange Commission (hereinafter referred to as "SEC") filed an *amicus curiae* brief supporting the complaint. All motions were denied (R. 17).

Subsequently the District Court certified to the Court of Appeals for the Seventh Circuit, the question of whether withdrawable capital shares in a savings and loan association are securities within the meaning of the Exchange Act for the purposes of an interlocutory appeal pursuant to § 1292 (b) of the Judicial Code [28 U.S.C. 1292 (b)] (R. 32). The court below granted leave to file such interlocutory appeal.

The Court of Appeals for the Seventh Circuit, with Judge Cummings dissenting, held that a withdrawable capital account in an Illinois-chartered savings and loan association was not a "security" within the meaning of that term as it is used in the Securities Exchange Act of 1934 and therefore the District Court lacked jurisdiction of this cause (R. 52).

Upon a petition for writ of *certiorari* to the United States Court of Appeals for the Seventh Circuit filed by petitioners herein supported by the SEC in an *amicus curiae* brief, the City Savings Association, including the three liquidators, and respondents herein filed briefs in opposition³ thereto, this Court granted *certiorari* (R. 66).

3. Defendants, C. Oran Mensik, Robert M. Kramer, Stanley Pasko, Joseph Talarico, Jr., Gloria Mensik

PREFATORY STATEMENT

Besides being named nominal defendants herein, the interest of respondents Knight and Hulman, who, as state officers, are charged with the duty of regulating and supervising all Illinois savings and loan associations (Ill. Rev. Stat. 1965, ch. 32, par. 701 *et seq.*) is to see that all depositors therein are properly protected and treated fairly and equally.

The petitioners, who are allegedly a group of account holders in City Savings Association, an association under the supervision of the respondents herein, claim that they are part of a class of such account holders consisting of some 5,000 persons who were issued such accounts by the association 5 years prior to the institution of the present action (Pet. Brief p. 4).⁴ Petitioners are not the only depositors since there are many people who had deposited their money in City Savings Association for many years prior to July 23, 1959. If petitioners are ultimately and

Sprincz, Robert Franz and Herbert J. Hoover, who were various officers and directors of City Savings prior to the time respondent Knight took custody (R. 2-3) did participate in the lower courts, and they have recently filed an appearance in this Court.

4. It is apparent that petitioners, basing their claim upon a violation of Section 10(b) of the 1934 Act (15 U.S.C. 78 j(b)) and Rule 10 b-5 thereunder, contend the state statute of limitations would apply (Ill. Rev. Stat. 1965, ch. 83, par. 16) (See *Errion v. Connell*, 236 F. 2d 447, 455 (C.A. 9); *Fratt v. Robinson*, 203 F. 2d 627, 634 (C.A. 9); *Fischman v. Raytheon Mfg. Co.*, 188 F. 2d 783, 787 (C.A. 2)).

completely successful in the outcome of this litigation⁵ the pre-1959 account holders would share *pro rata* in what little is left after petitioners and the class they allege they represent (if a class action is maintainable), collect their purchase price in full. Such a result would be unconscionable and really create a chaotic situation among the remaining depositors.

This type of dilemma was never intended by Congress when it enacted the Securities Exchange Act of 1934, especially when there are no cases interpreting the term "security" under that Act. Congress foresaw some of these problems when it decided to allow the state regulatory agencies to handle the failures of savings and loan institutions by exempting them from the Bankruptcy Act.⁶ This is particularly true where the state officers are better suited to permit and provide a more equitable solution than to allow petitioners to prevail over other depositors merely by a fortuity of time and on an erroneous interpretation of the Exchange Act (R. 31, 51).

SUMMARY OF ARGUMENT

Upon an analysis of the legislative history and intent of Congress after the 1929 crash, it is apparent that in Congress' attempt to regulate securities it never intended to include coverage of savings and loan accounts under the Exchange Act. Although specific attention was made to the precise account herein at issue, since they were well

5. See *supra*, p. 4.

6. 11 U.S.C. 22. Also see *Security Building and Loan Association v. Spurlock*, 65 F. 2d 768, 771 (C.A. 9); *Home Savings and Loan Association v. Plass*, 57 F. 2d 117 (C.A. 9); (R. 48).

known and discussed at length in hearings prior to the re-drafting of the present Securities Act of 1933 (hereinafter referred to as the "1933 Act") and in the Securities Act itself, they were tangentially referred to as not being within the provisions of the Securities Exchange Act of 1934 (hereinafter referred to as the "1934 Act"). Basically this is due to the fact that although there is a continuity in the scheme of regulating securities the purposes of the 1933 Act and 1934 Act are different. The 1933 Act sought full disclosures with regard to the issuance of various securities and transactions therein covered while the 1934 Act, on the other hand, is primarily concerned with the regulation of the trading and subsequent disposition of securities therein covered (15 U.S.C. 78b, App. p. 45). Therefore a purely formalistic approach without regard to the purpose or substance particularly in regard to the regulation of securities has been condemned by this Court. *SEC v. C. M. Joiner Leasing Corp.*, 320 U.S. 344, 350-351.⁷

Furthermore, the nature of the type of transaction involved in opening a savings and loan account, its dominant and fundamental characteristics as opposed to its less significant attributes; its resemblance to other transactions, e.g. deposits in a savings bank or a savings account in a commercial bank and its similarity to insurance, obviously excluded from the 1934 Act, all militate to the conclusion that these accounts are excluded from the coverage of the 1934 Act.

7. Also see *SEC v. Universal Service Association*, 106 F. 2d 232, 237 (C.A. 7) (writ of *certiorari* denied 308 U.S. 622); 163 A.L.R. 1053.

ARGUMENT

I.

THE INTENT OF CONGRESS WAS TO EXCLUDE SAVINGS AND LOAN ASSOCIATION ACCOUNTS FROM WITHIN THE COVERAGE OF THE SECURITIES EXCHANGE ACT OF 1934.

A.

The legislative history of the 1933 Act and 1934 Act.

Shortly after the 1929 stock market crash, Congress, at the instance of President Franklin D. Roosevelt, began to investigate the securities field and markets.⁸ As an outgrowth of such investigation the 1933 Act was passed for the general purpose of requiring full disclosure by all sellers of securities so that instead of *caveat emptor*, the maxim in this field would be "Let the seller also beware" while the 1934 Act was primarily intended to regulate the trading of various securities and markets.¹⁰

Many drafts of both proposed bills were introduced in the 73rd Congress before each was enacted into law.¹¹ Both

8. S. Res. 84, 72d Cong. (1932), S. Res. 56 and Res. 97, 73d Cong., (1934); S. Rep. No. 1455, 73d Cong., 2d Sess. (1934).

9. H. Rep. No. 85, 73d Cong., 1st Sess. 2 (1933).

10. H. Rep. No. 1383, 73d Cong., 2d Sess. (1934); 78 Cong. Rec. 7595, 7938-7940 (1934); 15 U.S.C. 78b, App. 45.

11. Prior to the 1933 Act, besides other hearings being held (Footnote 8, *supra*) the following bills were considered: H.R. 4314 and S. 875 and prior to the 1934 Act the following bills were on record: H.R. 7852, S. 2693, H.R. 8720 and S. 3420; 78 Cong. Rec. 7935 (1934).

the 1933 Act and the 1934 Act were managed in the House of Representatives by the House Committee on Interstate and Foreign Commerce, chaired by Congressman Sam Rayburn and in the Senate by the Senate Committee on Banking and Currency, chaired by Senator Duncan Fletcher. Although hearings and testimony were taken on other bills¹² the ones that finally became the 1933 Act and 1934 Act were H.R. 5480 (1st session) and H.R. 9323¹³ (2nd session), respectively.¹⁴

There were apparently no specific hearings held on H.R. 5480 in 1933 but there were hearings conducted on H.R. 4314 and S. 875.¹⁵ Likewise it appears no testimony was taken in 1934 on H.R. 9323 but this bill was debated quite extensively in Congress.¹⁶

12. *Id.*

13. Title II of H.R. 9323 enacted various amendments to the 1933 Act including redefining the term "security" in the 1933 Act. 78 Cong. Rec. 10258 (1934).

14. H.R. 5480 (1933) became Public No. 22, 77 Cong. Rec. 5195 (1933) and H.R. 9323 (1934) became Public No. 291, 78 Cong. Rec. 10847 (1934).

15. Hearings on H.R. 4314 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 1st Sess. (1933) and Hearings on S. 875 before the Senate Committee on Banking and Currency, 73d Cong., 1st Sess. (1933).

16. Hearings were held on H.R. 7852 and H.R. 8720, 73d Cong., 2d Sess. (February 14 to March 24, 1934). Debate in the House of Representatives on H.R. 9323, 78 Cong. Rec. 7693-10265 *passim*, 73d Cong., 2d Sess. (1934). Debate in the Senate was in part limited to S. 3420 which was similar to H.R. 9323, 78 Cong. Rec. 8160-8713, *passim*, 73d Cong., 2d Sess. (1934).

Securities Act of 1933.

After the hearings were conducted on H.R. 4314 with its obvious shortcomings¹⁷ the House Committee on Interstate and Foreign Commerce reported out H.R. 5480.¹⁸

After some short debate both Houses passed H.R. 5480 in 1933 but with various differences. Consequently conferences were held between the House and Senate resulting in the Act finally being passed in 1933.¹⁹

It has been repeatedly said that the primary purpose of the 1933 Act was to "provide full and fair disclosure of the character of securities sold in interstate and foreign commerce and through the mails, and to prevent frauds in the sale thereof."²⁰ Its purpose was to assure full publicity and information of "every issue of new securities to be sold in interstate commerce."²¹ Concern was placed on ensuring every possible element be made known to the purchaser upon the *issuance* of a security.

As stated in the SEC brief (p. 18), representatives of the United States Building and Loan League testified on

¹⁷ 17. The late Dean Landis, who was one of the principal drafters of the present 1933 Act, has commented on the legislative history of that law. Landis, *The Legislative History of the Securities Act of 1933*, 28 Geo. Wash. L. Rev. 29 (1959).

18. H.R. Rep. No. 85, 73d Cong., 1st Sess. (1933); 77 Cong. Rec. 2908 (1933).

19. H.R. Rep. No. 152, 73d Cong., 1st Sess. (1933); 77 Cong. Rec. 3900 (1933).

20. *Ibid*, p. 23, 77 Cong. Rec. 3901 (1933).

21. H.R. Rep. No. 85, *supra* 2 (Emphasis added); S. Rep. No. 1455, 73d Cong., 2d Sess. 151-152 (1934).

H.R. 4314, a bill containing few exemptions and later scrapped for H.R. 5480.²² Mr. Bodfish was testifying about the identical interests herein in question before this court i.e. withdrawable capital accounts or shares, when he said:

"I can describe the operation, best by saying that building and loan investments or shares are more similar to long-time deposits in mutual savings banks than they are to issues of stock or flotations of bonds."²³

The new authors who finally drafted H.R. 5480 did incorporate various exemptions within the 1933 Act.²⁴ When that bill was reported out of the House it stated, *inter alia*,

"Paragraph (5) exempts the securities of building and loan associations and similar institutions, but insists that such institutions as a condition to being exempt from the act must do a true building and loan business by confining their business to the making of loans to their members."²⁵

The final conference report by the House, to resolve the differences between the two Houses, contained the following:

22. 28 Geo. Wash. L. Rev. 29, 31 (1959).

23. Hearings on H.R. 4314 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 1st Sess. 72 (1933). Also see Hearings on S. 875 before the Senate Committee on Banking and Currency, 73d Cong., 1st Sess. 94-120, *passim* (1933).

24. 15 U.S.C. 77 c.

25. H.R. Rep. No. 85, 73d Cong., 1st Sess. 15 (1933). Also see Jennings and Marsh, *Securities Regulation*, p. 365 (1963).

"The House bill (sec. 3 (a) (5)) exempted the securities of building and loan associations and other similar institutions when their business was substantially confined to their members. The Senate amendment limited this exemption by further requiring that these associations must not charge withdrawal or other fees in excess of 2 percent of the face value of the security. This provision in the Senate amendment was accepted with the change of extending the exemption only to institutions that did not charge in excess of 3 percent of the face value of the security by way of a withdrawal fee or otherwise.

"The Senate amendment also exempted the securities of farmers' cooperatives. This exemption is incorporated in the substitute.

"The Senate amendment provided for an exemption in the case of annuity contracts. The House bill contained no such exemption. The substitute, however, only exempts such contracts when issued by a corporation subject to the supervision of the appropriate State or Territorial governmental agency."²⁶

The result appears in section 3(a) (5) of the 1933 Act.²⁷ It may be observed that the exemptions provided for in section 3(a) of the 1933 Act (15 U.S.C. 77 c (a))²⁸ are not applicable to sections 12 (2) and 17 of the 1933 Act (15 U.S.C. 77 l (2) and 77 q, respectively) sometimes referred to as the anti-fraud provisions of the 1933 Act.

26. H.R. Rep. No. 152, 73d Cong., 1st Sess. 24 (1933), 77 Cong. Rec. 3901 (1933).

27. 15 U.S.C. 77 c (a) (5).

28. With the exception of section 3(a) (2) of the 1933 Act (15 U.S.C. 77 c (a) (2)).

Securities Exchange Act of 1934

As in the case of the 1933 Act many shortcomings and objections arose after hearings were conducted on H.R. 7852, 8720²⁹ and S.2693 (companion to H.R. 7852).³⁰ There was a great deal of redrafting and rewriting of various sections apparently not related to the issue herein.

Subsequently the Senate reported out S. 3420 and the House reported out H.R. 9323.³¹

Debate then ensued on both bills when the Senate substituted H.R. 9323.³² The final bill was reported in the conference report by both Houses, which report contained a statement explaining parts of the bill.³³

Although the 1934 Act represents a continuous scheme in the regulation of securities, its purpose and the evils attempted to be remedied are distinct from the 1933 Act.³⁴ This bill was denominated as the bill "to provide

29. Hearings on H.R. 7852, 8720 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess. (1934); 78 Cong. Rec. 7935 (1934).

30. S. Rep. No. 792, 73d Cong., 2d Sess. 1 (1934).

31. *Id.*; 78 Cong. Rec. 6980 (1933) and H. Rep. No. 1383, 73d Cong., 2d Sess. (1934); 78 Cong. Rec. 7595 (1934).

32. 78 Cong. Rec. 8713 (1934).

33. H. Rep. No. 1838, 73d Cong., 2d Sess. (1934); 78 Cong. Rec. 10248-10265 (1934).

34. The 1934 Act contains a specific section setting forth its purpose (15 U.S.C. 78b) *infra*, p. 45, while the 1933 Act does not contain such provision. Also see Loomis, *The Securities Exchange Act of 1934 and the Investment Advisers Act of 1940*, 28 Geo. Wash. L. Rev. 214, 215 (1959).

for the regulation of securities exchanges and of over-the-counter markets operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets."³⁵

"The chief provisions of the bill may be grouped under six headings: (a) control of credits; (b) control of manipulative practices; (c) provision of adequate and honest reports to securities holders by registered corporations; (d) control of unfair practices of corporate insiders; (e) control of exchanges and over-the-counter markets; (f) administration."³⁶

The whole tenor of the 1934 Act was to control securities that are traded and the traders of such securities. Moreover the constant concern was to enhance credit and give integrity to the type of securities constantly being transferred from one person or institution to another.

Almost permeating throughout the hearings, reports and debates was the theory to protect the investments made and the operations of banks, insurance companies and savings and loan associations as opposed to the interests held by individuals in these enterprises.³⁷

35. 78 Cong. Rec. 10248 (1934).

36. 78 Cong. Rec. 7703 (1934).

37. H. Rep. No. 1383, 73d Cong., 2d Sess. 31 (1934); 78 Cong. Rec. 7702, 7864, 8017-8021, *passim*, 8097-8098, *passim*, 8187-8190 *passim*. Hearings on H.R. 7852, H.R. 8720 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 620, 648, 685, 720, 817; Hearings on S. Res. 84 (72d Cong.) and S. Res. 56 and S. Res. 97 (73d Cong.) before the Senate Committee on Banking and Currency, 73d Cong., 2d Sess. 7273 (Letter from National Association of Mutual Savings Banks) (1934).

No mention was made of trading of savings account interests but rather to protect the investments made by such institutions.

It is apparent that a review of the preliminary hearings and the debates of these bills evidence no intent by Congress to include withdrawable capital accounts of savings and loan associations within the provisions of the 1934 Act.

Senator Barkley commenting on a request for an exemption on another matter by another Senator retorted:

"MR. BARKLEY. The trouble about it is, as the Senator as a legislator knows, is trying to exempt everybody who feels that, although he is probably by the language of the bill not included, somebody, after a while may interpret him to be included, that we might unwittingly exempt many people who ought to be included. That is the difficulty about it.

.

"MR. BARKLEY. Section 2 of the bill itself says that only those included in the proposed law. Why should anybody imagine that someone else will be included in it?"³⁸

The 1964 Amendments to the Securities Exchange Act of 1934.

After necessity was found to further regulate the over-the-counter markets and those trading in them, Congress enacted various amendments to the 1934 Act.³⁹ A special

38. 78 Cong. Rec. 8190 (1934). Section 2 referred to in App. 45.

39. S. 1642, 88th Cong., 2d Sess. (1964); Public Law 88-467, 78 Stat. 565.

study was prepared by the SEC before hearings were conducted on H.R. 6789 and H.R. 6793 and S. 1642 in 1963. These bills provided for registration of certain equity securities. In the technical statement prepared by the SEC, while referring to all other interests which it recommended for exemption as being "securities" it speaks of "share accounts" when referring to the savings and loan associations and concludes that there is "normally no trading interest"⁴⁰ in them.⁴¹

Further amplification is made by the testimony of Professor William Cary, then Chairman of the SEC and Mr. Milton Cohen, Director of the Special Study for the SEC:

"MR. CARY. Well, sir, we do not have any jurisdiction over building and loan associations generally, and I thought (sic) they were subject to other Federal regulatory agencies.

MR. HARRIS. Did your study deal with that subject at all?

"MR. CARY. It did not; no, sir.

"MR. HARRIS. I want to know why it didn't.

"MR. COHEN. This is another area that the study group did not reach because of the number of other areas they were looking at. In the case of building and loan associations, and that type of organization, frequently the interest in the association is limited to a person who is a member of the association, with savings-type interest, in an association from which he may also borrow funds. There are various kinds of

40. S. Rep. No. 379, 88th Cong. 1st Sess. 61 (1963) (See also SEC Brief, p. 14. footnote 10, [S]avings and loan interest[s] is not a usual medium for trading in the markets.")

41. The exemption is contained in 15 U.S.C. 781 (g) (2) (C).

these organizations; when organizations of the kind sell stock as a stock investment, they are within the purview of the Federal Securities Act, as is proposed in this bill.

"This is a matter which is under discussion among the various agencies concerned with these organizations.

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"MR. COHEN. If I could add to that, normally in many of these organizations the person who has an interest in the association is in the nature of a savings—a savings interest. He doesn't have anything that he can usually transfer, as he can a share of stock, but in more recent years there has been a development in this area whereby stock in these organizations has been created for sale to the public as an investment. It is in this particular area that attention is being given to them within the purview of the securities acts."⁴²

Congress as well as the SEC took the position that where there is normally no trading such an interest is not within the purview of the 1934 Act.

B.

Legislative history related to the withdrawable capital accounts or shares issued to petitioners by City Savings Association.

From the exhaustive analysis of the legislative history of the 1934 Act, Congress was well aware of the type of

42. Hearings on H.R. 6789, H.R. 6793 and S. 1642 before a Subcommittee of the House Committee on Interstate and Foreign Commerce, 88th Cong., 1st Sess., 272-273.

interests herein at issue. Such interests were discussed, debated and thoroughly considered in Congressional reports, records and hearings. Withdrawable capital accounts, then, are distinguishable from the "variable schemes"⁴³ that may be perpetrated upon the public and which should ordinarily be curtailed or controlled within the statutory scheme.

However, there appears to be no desire by Congress to include these accounts under the 1934 Act since they were not the type of interests to be covered by the purposes or operation of the Act.

There is absolutely no suggestion or evidence by either petitioners or the SEC that Congress manifested an intent to include these types of accounts within the purview of the 1934 Act.

Instead both petitioners and the SEC's approach is merely formalistic without even attempting to look to substance.⁴⁴ Their reasoning throughout their briefs has been that if an instrument is identified in one piece of legislation as a "security" i.e., the 1933 Act, it is always and for all purposes a "security" wherever the same or similar definition is used without considering the purpose of that particular Act. In that connection it may be noted that the SEC is in error in quoting from S. Rep. No. 792, 73d Cong., 2d Sess. 14 (1934) (SEC Brief, pp. 10 and 20). That report referred to the term "security" in S. 3420 (not the final 1934 Act) which was "substantially the same as [that contained] in the Securities Act

43. See *SEC v. W. J. Howey Co.*, 328 U.S. 293, 299.

44. Such an approach has been looked upon with disfavor by this Court, *SEC v. C. M. Joiner Leasing Corp.*, 320 U.S. 344.

of 1933,"⁴⁵ but the term "security" was later changed after the conference of both Houses as appears in H. Rep. No. 1838, 73d Cong., 2d Sess. 3-4 (1934); 78 Cong. Rec. 10248 (1934).

In any event this Court has unequivocally stated with regard to interpreting securities legislation:

"Some rules of statutory construction come down to us from sources that were hostile toward the legislative process itself and thought it generally wise to restrict the operation of an act to its narrowest permissible compass. However well these rules may serve at times to aid in deciphering legislative intent, they long have been subordinated to the doctrine that

45. The term "security" was defined in S. 2693 (since S. 3420 is not available the writer understands that the definition of "security" was the same as in S. 3420) as follows:

"The term 'security' means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement, oil, gas, and other mineral royalties and deeds, collateral—trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, or in general, any instrument commonly known as a 'security', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing, *but the term 'security' as used in this Act shall not include any direct obligation guaranteed as to principal or interest by the United States.* (Emphasis added). Hearings on S. Res. 84, 72d Cong. (1932); S. Res. 56 and S. Res. 97, before the Senate Committee on Banking and Currency, 73d Cong., 2d Sess. 6423 (1934).

courts will construe the details of an act in conformity with its dominating general purpose, will read text in the light of context and will interpret the text so far as the meaning of the words fairly permits so as to carry out in particular cases the generally expressed legislative policy." (Footnotes omitted)⁴⁶

This Court has also held that when dealing with federal statutes the meaning of terms therein contained are federal questions. Mr. Justice Douglas in discussing the meaning of "insurance" and "annuity" as it is used in the 1933 Act and the Investment Company Act of 1940 (15 U.S.C. 80 a) in *SEC v. Variable Annuity Life Insurance Co.*, 359 U.S. 65 at page 69 (1959) said:

"In any event how the States may have ruled is not decisive. For, as we have said, the meaning of 'insurance' or 'annuity' under these Federal Acts is a federal question."⁴⁷

Since the issue in the instant case is a "federal question" it is necessary to construe the details of the 1934 Act in conformity with its "dominating general purposes" and read the "text in the light of context" and conclude that withdrawable capital accounts in the Illinois savings and loan association are not a "security" within

46. *SEC v. C. M. Joiner Leasing Corp.*, 320 U.S. 344 at pages 350-351. Also see *SEC v. Universal Service Association*, 106 F. 2d 232, 237 (C.A. 7) (writ of certiorari denied); 163 A.L.R. 1053.

47. Also cited to by Mr. Justice Harlan in *SEC v. United Benefit Life Insurance Co.*, 387 U.S. 202, 210.

the meaning and intent of the 1934 Act as set forth in the "generally expressed legislative policy."⁴⁸

Possibly the only hint of any Congressional consideration of share accounts with regard to the 1934 Act was the 1963 hearings and the subsequent exemption made in the 1964 amendments. On the basis of this discussion and the exemption it is erroneous to conclude that there was any intent to include such accounts in the rest of the 1934 Act since such reasoning is what Professor Louis Loss calls supererogation.⁴⁹ Just as an exemption was made in the 1933 Act for "insurance" there is no implication that there was any intent to include "insurance" within the ambit of the 1933 Act.⁵⁰

Neither petitioners nor the SEC cite any case that either holds that Congress intended to include withdrawable accounts in the 1934 Act or that the courts even held that these identical interests at issue herein, were construed to be a "security" under the 1934 Act.⁵¹

48. Note that the definitions contained in Section 3(a) of the 1934 Act (15 U.S.C. 78c), *infra*, p. 47, starts "3.(a) When used in this title, unless the context otherwise requires".

49. 1 Loss, *Securities Regulation*, (1961 ed.) p. 497.

50. Section 3 (a) (8) of the 1933 Act (15 U.S.C. 77 c (a) (8)).

51. Almost all the cases cited relate to the meaning of the term "security" under the 1933 Act or under state law (not here relevant since as this Court has held this is a "federal question", footnote 47, *supra*). The court in *Archer & Co. v. SEC*, 133 F. 2d 795 (C.A. 8), *certiorari* denied, 319 U.S. 767, to the contrary appears to be discussing face-amount certificates, rather than share accounts, as contemplated under the Section 2(a) (15) of the Invest-

Even a review of the allegations in the complaint in the present matter is further support that the petitioners are only concerned with the issuance of the accounts to them. Not one allegation is made that there was a *sale* from one account holder to another party. All petitioners are purchasers of accounts (R. 4-5).

The SEC concedes that the decision of the court below has no effect on share accounts under the 1933 Act.⁵² There is no strong policy reason to have share accounts come under the 1934 Act since there are no sales of them except at issuance by the savings and loan associations.⁵³

ment Company Act of 1940 (15 U.S.C. 80a-2(a)(15)) which usually fluctuate due to their active trading. Furthermore, there is no indication that the institution involved was a true building and loan association which limited its business to its members as in the instant case. In the *Los Angeles Trust Deed and Mortgage Exchange v. SEC*, 285 F. 2d 162 (C.A. 9), *certiorari* denied, 366 U.S. 919, the court after concluding that a "security" was involved under the 1933 Act, did not even discuss whether this "variable scheme" was a "security" under the 1934 Act. There were also repurchases of these instruments at discounts as well as further sales. Moreover the enterprise sought to be enjoined and which later ended up in receivership was not regulated by any governmental agency except the SEC. All of these factors distinguish the *Los Angeles Trust Deed* case from the instant action.

52. See footnote 2 in the SEC brief, p. 3.

53. Those whom the SEC contend are solicitors of such accounts are covered under the anti-fraud provisions of the 1933 Act (Sections 12(2) and (17); 15 U.S.C. 77 l (2) and 77q). If the solicitors violate the 1933 Act the SEC may still exercise control under specific provisions of the 1934 Act which relate to 1933 Act violations (15 U.S.C. 78o(b)(5)(D)(E) and 78o-3(1)(2)(B)). These solicitors never trade these accounts but merely open accounts in

Nor have the petitioners cited any authority of any sort to show why this action must be maintained under the 1934 Act.

There have been many commentaries on the possible abuse of litigants of Rule 10b-5 promulgated under the 1934 Act especially when no remedy may be available under the 1933 Act. There is no special contention raised by petitioners that they only have a claim, if any, under the 1934 Act. Nevertheless they only seek relief under the 1934 Act and none under the 1933 Act.

In any event, Professor Louis Loss has written a critique in his treatise regarding the gravitation of almost all claims for recovery under Rule 10b-5 with little recourse to other provisions of both the 1933 and 1934 Acts. In discussing the number of cases arising under Rule 10b-5, he wrote:

"With deference to the court, is not this potpourri the *reductio ad absurdum* of the view which opens Rule 10b-5 and § 17(a) to buyers who for some reason find their express remedies under the 1933 act to be inadequate? . . . Rule 10b-5 was adopted to protect defrauded sellers, whom Congress had largely overlooked in its concern for defrauded buyers under the 1933 act. . . .

solely federally insured savings and loan associations (SEC brief pp. 4, 23-24). Such registration requirement was innovated after the SEC filed its *amicus* brief in the trial court in 1964. Moreover, the activities of these solicitors have been severely curtailed by the Federal Home Loan Bank Board, Board of Governors of the Federal Reserve System and Federal Deposit Insurance Corporation by reducing the amounts they may place in various institutions and the amount of commission that they may receive. (See Federal Home Loan Bank Board Regulation 563.25, 12 C.F.R. § 563.25).

"The danger, of course, is that the continued denigration of buyer's express remedies under the 1933 act in favor of Rule 10b-5, and even § 17(a) of the 1933 act itself, may persuade the Supreme Court—which has yet to consider *any* implied remedy under the SEC statutes—to throw its collective hands up and the *Kardon* doctrine out. To be sure, the approach advocated here leaves the basic anomaly of favoring sellers, for whom by and large Congress created no specific remedies, over buyers, who were taken care of in some detail in the Securities Act. Yet, apart from abandoning sellers to their common law remedies there seems to be only one other alternative open: The courts might try to make a logical pattern by reading the defenses and limitations of §§ 11, 12, 13 and 15 of the Securities Act into *sellers'* actions under Rule 10b-5. But that would require too substantial a judicial rewriting of the statutes. Consequently, it seems relatively safe to predict that the Supreme Court will someday have to choose between abandoning the seller altogether and accepting the anomaly of favoring him over the buyers as inevitable under a system of securities regulation which after all is not an integrated code adopted at a single legislative sitting, however one may try to construe it so."⁵⁴

Of course, it is not necessary for the Court to even go as far as Professor Loss suggests but merely to hold that savings and loan accounts were not intended to come within the purview of the 1934 Act and therefore no claim is stated herein under Rule 10b-5 thereunder.

54. 3 Loss, *op. cit.*, pp. 1789-1790.

II.

THE NATURE OF A SAVINGS AND LOAN ASSOCIATION ACCOUNT WAS NOT INTENDED TO FIT WITHIN THE MEANING OF THE TERM "SECURITY" AS USED IN THE SECURITIES EXCHANGE ACT OF 1934.

A.

The Nature of a Savings and Loan Association Account.

Even though there is no Congressional intent to include a withdrawable capital account within the scope of the 1934 Act an approach that construes the basic, fundamental and dominant characteristics of this transaction is further support that such an instrument is not within the meaning of the term "security" in the 1934 Act.

The interests that are involved in this case universally come into being as follows: when a person opens up a withdrawable capital account, more commonly known as a "savings account," in any savings and loan association, including the one herein at issue, he submits some money to the association and he signs what is usually called a "signature card." This "signature card," besides identifying the person, does indicate that it constitutes that person's proxy in the association and makes him a "member" thereof. At that time he is usually issued a passbook or certificate, which would reflect the amount of the deposit thereon. Normally, nothing further is done by the person nor the association, except the entry in the passbook of other deposits or withdrawals of money and dividends that are declared by the association.

While the becoming of a "member" in a going and thriving savings and loan association does create a proprietary

interest within the association under the Illinois Savings and Loan Act, (Ill. Rev. Stat. 1965, ch. 32, par. 701 *et seq.*) such a position is more nominal than real. The person who has opened such an account probably is solely interested in keeping his money in a place to earn dividends.

Although there are voting rights attached to the share account, the technical and almost surgical approach by particular petitioners (Pet. Brief, pp. 4-14) and in some measure by the SEC (Sec. Brief, pp. 5-7) without looking to the reality of this transaction indicates once again that only form is being entertained over substance.

Therefore, the outstanding characteristics of this account besides what has been stated above are as follows: permissibly issued in unlimited amounts; as not made subject to the securities article of the Uniform Commercial Code; as not negotiable and transferable only by assignment; as subject to forced redemption and retirement on call of the board of directors; as fully matured and withdrawable when issued; as without preemptive rights and as the limited right to inspect the books and records of the association solely as to his own account (R. 47).

It is possible that when a person's account is in an institution which has suffered financial difficulties his voting rights may be of some importance as in the instant case. Nevertheless, as will be discussed later, state regulation controls, not the Bankruptcy Act.⁵⁵

What, then, is the "economic reality"⁵⁶ of the placing of money in a savings and loan association and the receipt by such person of a passbook? Surely his voting

55. See footnote 6, *supra*.

56. *SEC v. W. J. Howey Co.*, 328 U.S. 293, 298.

rights are neither thought of nor of any concern. His only desire is to accumulate a balance, receive dividends and withdraw his money on demand and he almost always does. There is no need to purchase or sell his account since he will have the same status merely by opening or withdrawing such an account in any going institution.

It is apparent that something besides an "equity" is involved. The savings and loan account holder does not even consider himself in that capacity, since his only concern is to be able to have the association return to him the dollar value of his account on demand, together with credited earnings. This is precisely the same characteristic of any short-term debtor-creditor relationship. His interest under various historical precedents, also has been construed to be in the debtor-creditor category.⁵⁷

It has also been shown that the withdrawable capital account is very much like a deposit in a commercial bank's savings account or mutual savings bank.⁵⁸ There is even a strong Congressional policy to treat these accounts alike for purposes of federal insurance⁵⁹ and under the Internal Revenue Code.⁶⁰

57. Prather, *Savings Accounts in Savings and Loan Associations* 15 Bus. Law. 44-69 (1959); *Benton's Apparel v. Hegna*, 213 Minn. 271, 7 N.W. 2d 3; *Bakerstown (In re Kruger's Estate)*, 39 P. 2d 381 (Sup. Ct. Wash.) *Savings Association*, 122 A. 2d 411 (1956); *Costine v. Whitham (In re Krueger's Estate)*, 39 P. 2d 381 (Sup. Ct. Wash. (1934); *Harn v. Woodward*, 50 N.E. 33.

58. *Ibid.* Livingston, *Chicago Daily News*, September 28, 1967, p. 51 and October 3, 1967, p. 35.

59. 12 U.S.C. 1726.

60. 26 U.S.C. 591.

There has been a decided interest to be sure especially under federal legislation, to treat the withdrawable capital account much like other savings accounts.

This was particularly emphasized by the chairman of the SEC during the 1963 hearings on the proposed amendments to both the 1933 Act and 1934 Act.

"Both bills would apply to bank securities to the same extent as they would apply to the securities of other corporations with securities traded in the over-the-counter market. There is also no disparity between the treatment accorded securities issued by banks and savings and loan associations of similar institutions. Since deposits in savings and loan type associations, unlike deposits in banks are represented by share accounts and depositors are commonly referred to as shareholders, section 6 (c) of the bills provides an exemption from the registration requirements of the bills for securities issued by such institutions 'other than permanent stock, guarantee stock, permanent reserve stock, or any similar certificate evidencing notwithdrawable capital.' *The sole purpose of this exemption is to assure that depositors in savings and loan associations and similar institutions are treated exactly as bank depositors and not as shareholders of equity securities for the purpose of the coverage criteria contained in the bills.*"⁶¹

The need for equal treatment is seen in the competitive desire of banks, savings and loan associations and

61. Hearings on H.R. 6789, H.R. 6793 and S. 1642 before the Subcommittee of the House Committee on Interstate and Foreign Commerce, 88th Cong., 1st Sess. 1361 (1963) (Emphasis added); Also see footnotes 23, 42, *supra*, H.R. Rep. No. 234, 73d Cong., 1st Sess. (1933).

similarly regulated institutions to encourage people to open accounts.⁶²

In a sense a life insurance policy or a fixed annuity (not "variable" as construed by this court in *Variable Annuity* case, *supra* and *United Benefit* case, *supra* but as understood under the 1933 Act)⁶³ is very much like a savings and loan association account since the policyholder in a mutual company has virtually the same rights and duties as a member of a savings and loan association.⁶⁴ Such a policyholder has voting privileges but his main interest is in the nature of the policy⁶⁵ which is in the form of forced savings and protection upon his death or income at some future date. He is also entitled to dividends as an account-holder in a savings and loan association.⁶⁶

The similarities between mutual savings and loan associations and mutual insurance companies were recognized by the SEC in 1963. The following is the testimony that

62. Dividend and interest rates are invariably set by the regulations of the Federal Home Loan Bank Board Federal Deposit Insurance Corporation, Federal Savings and Loan Insurance Corporation, Board of Governors of the Federal Reserve System and Comptroller of the Currency.

63. See footnote 26, *supra*.

64. Ill. Rev. Stat. 1965, ch. 73, par. 613 *et seq.*

65. Ill. Rev. Stat. 1965, ch. 73, pars. 647-677 *passim*. So too is the account-holder's form subject to the approval of the Illinois State Commissioner of Savings and Loan Associations. Ill. Rev. Stat. 1965, ch. 32, par. 768(a).

66. Ill. Rev. Stat. 1965, ch. 73, par. 666.

transpired by Mr. Cary regarding the amendments suggested at that time which were enacted in 1964:

"With respect to savings and loan associations, an effort is made to treat them in essentially the same manner as insurance companies are treated, that is, mutual savings and loan associations will be exempt, just as mutual insurance companies are.

"In the case of stock savings and loan associations, the stock, if purchased and traded as an equity investment, is subject to H.R. 6789 just as is stock of insurance companies.

"On the other hand, savings accounts in savings and loan associations are not subject to the bill, just as insurance policies are not covered. Because of the fact that most savings and loan associations issue so-called shares, which in fact merely evidence the existence of a savings accounts, special provision had to be made in proposed section 12 (g) (2) (C) of the bill to exempt that type of 'share.'"⁶⁷

He also said:

"MR. CARY. We didn't make that statement, but we do say that mutual insurance companies are not included under the bill because the buyers of mutual insurance companies are fundamentally buying insurance. That is the first point. They are buying an insurance policy and not stock. Furthermore, because there is no stock, there is no trading in the stock.

"On the other hand, in stock companies, investors may be stockholders without even having an insurance policy in the company.

"In stock companies, we are interested in providing information to people who are engaged in trading in that stock. They must have the information. In mu-

67. Hearings on H.R. 6789, H.R. 6793, and S. 1642 before a Subcommittee of the House Committee on Interstate and Foreign Commerce, 88th Cong., 1st Sess. 1213 (1963).

tual companies, there are no shares being traded and, therefore, they don't need to know this kind of information. That is why we draw a distinction, Mr. Chairman, between mutual insurance companies, on the one hand, and stock insurance companies, on the other.

"MR. HARRIS. In other words, if there is no public trading, then any management abuses are none of your business?"

"MR. CARY. They are none of our business legally, that is correct.

"I think the answer will be yes. It is not that we are not unhappy."

"Mr. Loomis has clarified that in my mind by pointing out that, since the holders in mutual companies are policyholders, any wrongdoing would be the responsibility of the State Superintendent of Insurance."⁶⁸

The majority of the court below placed great weight on the close resemblance of these two types of institutions and their treatment by Congress (R. 50-51) and properly so since this argument more closely than anything petitioners or the SEC have submitted evidences the intent of Congress.

It is also apparent that no matter how you treat the account holders or policyholders in any of the enterprises discussed above the risk is invariable on that institution and not on the individual while it is in operation.

Another erroneous approach taken by the petitioners is to consider this transaction on purely a semantic basis. Their circuitous argument is that since this is denominated a "share" or "stock" (SEC Brief, p. 13) in certain legisla-

68. House Hearings, *supra*, pp. 309-310.

tion or in testimony taken before Congressional hearings it is a share or stock and therefore a "security." This reasoning is fallacious since the terminology which is used is due to the historical development of savings and loan associations.

In analyzing the origins of the savings and loan association, Mr. Prather, general counsel to the United States Savings and Loan League, has indicated that the term "share" was used to encourage a mutuality or equality of status among the members of the association.⁶⁹ Further confusion was later caused by the various forms these shares in the mutual association would take i.e. due paid on installment plan shares, optional plan shares, pre-paid shares, etc. (Pet. Brief, p. 5). On top of all this was added the development of true stock associations (as opposed to a true building and loan association confining its business to its members)⁷⁰ which created a class of owners as in any stock-company.

In any event City Savings, a mutual association, confining its business to its members, employed nomenclature which is much closer to the true nature of the transaction. These accounts are more often than not referred to in the commercial world as "savings accounts".⁷¹

Nevertheless, the label employed is not the determining factor but the actual character and qualities of such accounts.

69. 15 Bus. Law. 52, 64.

70. See the testimony of Messrs. Cary and Cohen, pp. 17, 18 *supra*.

71. 15 Bus. Law. 52.

Therefore, a more reasonable analysis is to appraise the transaction within the economic realities and within the basic framework as understood by the parties there-to and as carefully considered by those who testified before Congressional hearings and in Congress itself.

B.

The term "security" under the 1934 Act.

It has been pointed out that not one case cited has considered the definition of "security" under the 1934 Act.⁷² It has also been shown that although the definition of security in Section 3(a) (10)⁷³ is similar in the 1933 and 1934 Acts, there are differences.

One is the omission of the term "evidence of indebtedness" and the other is the addition of the following:

"but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited."

It is suggested in both briefs heretofore filed that there is no apparent reason for this omission or addition, except the term "evidence of indebtedness" is inconsistent with the instruments excluded from the definition.

An analysis of the derivation of the exclusion reflects some basis on the transactions not included in the 1934 Act.

72. See footnote 51, *supra*.

73. 15 U.S.C. 78 (c) (a) (10).

The SEC has inferred that the exclusion was only intended to apply to short-term commercial paper.⁷⁴ Although there appears to be superficial merit to their argument there is no support in the legislative history of this exclusion. The exclusion has more far reaching effect than just commercial paper. Why then in section 15 of the Act originally passed in 1934 was there a reference to ". . . any security (other than an exempted security or commercial paper, bankers' acceptances, or commercial bills) . . ." if such paper were already not included.⁷⁵

Congress intended to exclude transactions other than short term commercial paper since it already excluded commercial paper in other sections of the 1934 Act. Furthermore if Congress intended to have the same definition in both the 1933 Act and 1934 Act then it would have enacted the identical definition. Therefore, the exclusion in a subsequent act with a similar definition evidences a specific intent not to include such or related transactions within that definition.

Another factor to be evaluated is the S. 2693 definition which excluded direct obligations guaranteed as to principal or interest by the United States (footnote 45, *supra*). Such instruments included Reconstruction Finance Corporation bonds and other such governmental securities. It was later decided to include these items in the "exempted security" class.⁷⁶

74. See SEC Brief, p. 22, footnote 17.

75. Section 15 of original act. In the amended act this same language has been employed. 15 U.S.C. 78c.

76. Section 3(a)(12) of the 1934 Act. (15 U.S.C. 78c (a)(12)) These and other government and municipal

It is therefore apparent that the exclusion in Section 3(a) (10) as quoted above is much broader and does include petitioners interests.

With the omission of evidence of indebtedness and the exclusion hereinabove set forth there are several factors that are related to these accounts.

The term "evidence of indebtedness" was deleted from the 1934 definition thereby leaving only notes, bonds and debentures in the debtor-creditor transactions.

One SEC release has shed some light on what constitutes an "evidence of indebtedness" under the 1933 Act which would be of some aid in the construction of the omission of such term under the 1934 Act. With regard to whether trading stamps were "evidence of indebtedness" the Commission view was that such stamps were not "securities" within the meaning of the 1933 Act. It was also said that streetcar tokens, meal tickets, Christmas gift certificates, box tops, railroad or theatre tickets and others too numerous to mention were also "evidence of indebtedness" not included within the purview of the 1933 Act. The release indicated the legislative history and other provisions of the statute indicate that the Congress did not intend to include such items within the scope of the statute."

Another development in the legislative history of term "security" is that the very bill H.B. 9323, that became the

bonds were actively traded on the over-the-counter markets and therefore there developed the "exempted security" class. Hearings on H.R. 7852, 8720 before the House Committee on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 685-687 (1934).

77. SEC Reg. § 231.3890, Release No. 33-3890 (1958). Also see 1, Loss, *op. cit.*, pp. 455, 495.

1934 Act contained an amendment to the 1933 Act definition of "security" which retained the term "evidence of indebtedness" without the exclusion as set forth above.⁷⁸

Couple this with the specific language of transactions *not included* in the definition of "security" under the 1934 Act, the only apparent ordinary debtor-creditor transactions remaining specifically included are long term notes, bonds and debentures.

C.

Relationship of the withdrawable Capital Account to the definition of "security" as it is used within the meaning of the 1934 Act.

Respondents are in full agreement and support of petitioners' appeal to have the 1933 Act and 1934 Act liberally and as broadly construed by this Court as it did in last term's decision.⁷⁹ Such a construction is made by complying with the specific intent manifested by Congress.

The 1934 Act definition of "security" bears a close relationship to the 1933 definition but has markedly different structure as described herein.

Likewise looking at the withdrawable capital account, as to substance rather than form and as the commercial world does, it most closely resembles an instrument arising out of a short-term debtor-creditor relationship than any other category in the definition of "security" in the 1934 Act.

78. 78 Cong. Rec. 10263 (1934) and footnote 13, *supra*.

79. *SEC v. United Benefit Life Insurance Co.*, 387 U.S. 202.

Such an understanding is borne out by the testimony that developed before one of the bills considered prior to the enactment of the 1933 Act.

The majority in the court below has placed emphasis on this development (R. 50).

In the hearings on S. 875 various Senators indicated that the term "evidence of indebtedness" bore a close relationship to accounts in building and loan associations and various short term banking transactions.⁸⁰

There appeared to be a desire to delete this phrase relating to debtor-creditor relations other than those enumerated due to the fear of banks and the Federal Reserve Board that it would "radically interfere with the ordinary commercial banking transactions"⁸¹ Instead of omitting the term, an amendment was made to the original proposed bill to exempt certain short-term debtor-creditor transactions (Section 3 (a) (3) of 1933 Act, 15 U.S.C. 77c(a) (3)). While the Senators were on that subject of such a proposed amendment to the pending Securities Act of 1933, in the taking of the testimony of Mr. Huston Thompson, attorney at law, before the Senate Committee, the following was interjected:

"SENATOR BARKLEY. Mr. Thompson, while on that subject let me ask you this question. Have you

80. Hearings on S. 875 before the Senate Committee on Banking and Currency, 73d Cong., 1st Sess. pp. 94-120 *passim* (1933).

81. Senator Glass' statement in Senate Hearings, *supra*, pp. 98-99.

given any thought to exempting building and loan associations."⁸²

Thereupon colloquy followed concerning the various types of associations that existed then, the various forms of accounts and stock issued much like what we discussed in this brief.

Senator Barkley further expressed his feeling regarding the nature of withdrawable accounts in building and loan associations by reading a telegram into the record from a Kentucky institution, as follows:

"Their stock is based on real estate mortgage and is similar to deposits in savings banks and different in every respect from stocks sought to be controlled."⁸³

Therefore we can see the very same 73rd Congress that passed the 1933 and 1934 Acts felt that the term "evidence of indebtedness" was very closely related to withdrawable accounts in savings and loan associations and banking transactions together with the desire to exclude withdrawable accounts from control under these acts.

Not one case cited by either petitioners or SEC specifically holds any transaction was a "security" under the 1934 Act;⁸⁴ no less a case regarding savings and loan accounts.

From the legislative intent, from the nature of the transaction, from policy reasons where there is state regulation, withdrawable capital accounts are not within

82. Senate Hearings, *supra* at p. 99.

83. Senate Hearings, *supra* p. 113.

84. See footnote 51, *supra*.

the meaning of the term "security" as defined in the 1934 Act.

D.

State Regulation of Withdrawable Capital Accounts.

Perhaps the most reasonable analysis accorded the dearth of case law on this issue was expressed by the SEC in their memorandum submitted in support of petitioners' writ for *certiorari* when it said:

"Perhaps because savings and loan associations are subject to state regulatory supervision, over the years the Commission has rarely found occasion to seek to enjoin violations of the federal securities laws by such associations and this accounts for the paucity of case law."⁸⁵

State regulation of savings and loan associations was of paramount consideration by this Court in *Hopkins Federal Savings and Loan Association v. Cleary*, 296 U.S. 315. That case arose during the depression and was decided subsequent to the enactment of the 1934 Act.⁸⁶ The atmosphere of the time was very dismal for such institutions due to the number of failures of these enterprises and other related types of organizations. The Court, nevertheless, in describing state savings and loan associations as being quasi-public instruments speaking through Mr. Justice Cardozo said:

"How they shall be formed, how maintained and supervised, and how and when dissolved are matters of governmental policy, which it would be an intru-

85. SEC's memorandum in support of Petition herein, p. 10.

86. Also see *Veix v. Sixth Ward Building and Loan Association*, 310 U.S. 32.

sion for another government to regulate by statute or decision, except when reasonably necessary for the fair and effective exercise of some other and cognate power explicitly conferred."⁸⁷

In the instant action as well as in that case the state's concern is other than "pecuniary"⁸⁸ but to protect and ensure equal treatment of all depositors as opposed to one class (petitioners).

Invariably the only time a situation may arise is when, as in the present matter, a savings and loan association is in liquidation due to financial reverses or even mismanagement. Clearly this is not the time for a group of depositors to recover in excess of his fellow depositors. This is where as this Court said in the *Hopkins* case, the state role is best suited to handle such situations. The SEC, has recognized this in both its memorandum submitted herein⁸⁹ and in the trial court, of this action when it supported respondents herein in opposition to petitioners' motion for an appointment of a receiver.

It is when an association is in liquidation that the state's regulatory function is peculiarly necessary in view of the exemption of such associations from the operation of the Bankruptcy Act.⁹⁰ It would result in a breakdown of such regulatory power if one group, merely by a fortuity of time and some alleged acts by management, should pre-

87. *Hopkins case, supra*, at page 337.

88. *Id.*, p. 339.

89. See p. 40, *supra*.

90. 11 U.S.C. 22. Also see *Hopkins case, supra*, pp. 328-329.

vail at the expense of others who are in the identical situation.

The SEC probably has been always sympathetic to this need for regulation up until the time it had filed an *amicus* memorandum in the trial court in 1964.⁹¹ This is apparent in the attitude the SEC took with regard to the ordinary types of "insurance" as opposed to the "variable annuity" situations which are not regulated as much as insurance by the state authorities.⁹²

When an institution is viable there is almost no likelihood of any contest by an account-holder or policyholder. The result is that almost invariably the investment risk is on the institution. To protect this risk these institutions are closely supervised by the state authorities.⁹³

91. There has been absolutely no regulation by the SEC of true savings and loan associations under the 1934 Act until the instant action. Prior thereto for more than 30 years the SEC has either taken the position that savings and loan associations and the accounts of their members are either exempt (Securities and Exchange Commission Release No. 26, October 22, 1934 relating to accounts in associations in liquidation) or not included (testimony of former SEC Chairman Cary, p. 31, *supra*). Since this case the SEC has taken a more active role with regard to savings accounts despite the restrictions put on the more than 96% of savings and loan associations, (See SEC Brief, p. 3, footnote 1) which are regulated not only by the state (Ill. Rev. Stat. 1965, ch. 32, par. 705) but by other federal agencies. (See letter of such agencies dated December 16, 1966). Also see footnote 53, *supra*.

92. *Variable Annuity* case, *supra*, at 68, 74 (concurring opinion); 99-101 (dissenting opinion); *United Benefit* case, *supra* at 210.

93. *Variable Annuity* case, *supra*, at 77-80, 91 (concurring opinion); 99-101 (dissenting opinion); *United Benefit* case, *supra* and *Hopkins* case, *supra*.

When an institution is in financial difficulties then the individual whose interest is in jeopardy seeks to extricate himself. Nevertheless even in this situation the state agencies are particularly adjusted to this role.

The liquidation process, although spelled out in the Illinois Savings and Loan Act,⁹⁴ has been summed up as follows:

"From the time of an officially determined insolvency or action to liquidate, however, the savers' creditorship status becomes classified as secondary to those outside creditors who must be paid first. They share pro-rata on a simultaneous and equal basis in the assets remaining."⁹⁵

Petitioners and the SEC have advanced no argument to change this logical and orderly liquidation of City Savings which is being supervised by the state.

Consequently no support is found in the statutes, legislative history, legislative intent, in any case, nor in any policy argument to overturn the decision below by the Court of Appeals for the Seventh Circuit.

94. Ill. Rev. Stats. 1965, ch. 32, pars. 901-927. Also see Ill. Rev. Stats. 1965, ch. 73, pars. 799-833 (liquidation provisions of the Illinois Insurance Code). Investments by insurance companies as well as savings and loan associations are regulated by statute. Ill. Rev. Stats. 1965, ch. 73, pars. 736-737.22a. For a comparison to savings and loans see Ill. Rev. Stats. 1965, ch. 32, pars. 791-804.

95. 15 Bus. Law. 63; Russell, *Savings and Loan Association*, p. 304 (2d ed.).

CONCLUSION

For the foregoing reasons, respondents Knight and Hulman respectfully pray that the judgment of the Court of Appeals for the Seventh Circuit be affirmed.

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APPENDIX

Section 2 of the Securities Exchange Act of 1934 reads as follows (15 U.S.C. 78b):

"Necessity for regulation

"For the reasons hereinafter enumerated, transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, including transactions by officers, directors, and principal security holders, to require appropriate reports, and to impose requirements necessary to make such regulation and control reasonably complete and effective, in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets in such transactions:

"(1) Such transactions (a) are carried on in large volume by the public generally and in large part originate outside the States in which the exchanges and over-the-counter markets are located and/or are effected by means of the mails and instrumentalities of interstate commerce; (b) constitute an important part of the current of interstate commerce; (c) involve in large part the securities of issuers engaged in interstate commerce; (d) involve the use of credit directly affect the financing of trade, industry, and transportation in interstate commerce, and directly effect and influence the volume of interstate commerce; and affect the national credit.

"(2) The prices established and offered in such transactions are generally disseminated and quoted

throughout the United States and foreign countries and constitute a basis for determining and establishing the prices at which securities are bought and sold, the amount of certain taxes owing to the United States and to the several States by owners, buyers, and sellers of securities, and the value of collateral for bank loans.

"(3) Frequently the prices of securities on such exchanges and markets are susceptible to manipulation and control, and the dissemination of such prices gives rise to excessive speculation, resulting in sudden and unreasonable fluctuations in the prices of securities which (a) cause alternately unreasonable expansion and unreasonable contraction of the volume of credit available for trade, transportation, and industry in interstate commerce, (b) hinder the proper appraisal of the value of securities and thus prevent a fair calculation of taxes owing to the United States and to the several States by owners, buyers, and sellers of securities, and (c) prevent the fair valuation of collateral for bank loans and/or obstruct the effective operation of the national banking system and Federal Reserve System.

"(4) National emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden interstate commerce and adversely affect the general welfare, and precipitated, intensified, and prolonged by manipulation and sudden unreasonable fluctuations of security prices and by excessive speculation on such exchange and markets, and to meet such emergencies the Federal Government is put to such great expense as to burden the national credit."

Section 3(a)(10) of the Securities Exchange Act of 1934, provides, 15 U.S.C. 78c(a)(10):

"3. (a) When used in this chapter, unless the context otherwise requires—

• • • • •

"(10) The term "security" means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust, certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a "security"; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited."

Section 10(b) of the Securities Exchange Act of 1934 is (15 U.S.C. 78j(b)) :

"Manipulative and deceptive devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

"(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule 10b-5 promulgated by the SEC pursuant to the Securities Exchange Act of 1934 is as follows (17 C.F.R. § 240, 10b-5):

"Rule 10b-5. Employment of Manipulative and Deceptive Devices.

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange

- (1) to employ any device, scheme, or artifice to defraud.**
- (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or**
- (3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,**

in connection with the purchase or sale of any security."

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IN THE
Supreme Court of the United States

OCTOBER TERM, 1967.

ALEXANDER TOHEREPNIN, et al.,

Petitioners,

vs.

JOSEPH E. KNIGHT, et al.,

Respondents.

**BRIEF FOR RESPONDENTS CITY SAVINGS
ASSOCIATION, DENNIS KIRBY, ET AL.,
LIQUIDATORS**

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IN THE
Supreme Court of the United States

OCTOBER TERM, 1967.

No. 104

ALEXANDER TCHEREPNIN, et al.,
Petitioners,

vs.

JOSEPH E. KNIGHT, et al.,
Respondents.

**BRIEF FOR RESPONDENTS CITY SAVINGS
ASSOCIATION, DENNIS KIRBY, ET AL.,
LIQUIDATORS**

QUESTION PRESENTED

Is a withdrawable capital account in an Illinois-chartered savings and loan association a "security" within the meaning of that term as it is used in the Securities Exchange Act of 1934?

STATEMENT OF THE CASE.

Petitioners devote two pages (Pet. Br. pp. 12-13) to allegations and charges of fraud and concealment committed by certain of the respondents. These allegations and charges have no relevance on this appeal. No issue is presented concerning the truth or falsity of any of the charges in the complaint. This appeal concerns only the correctness of the legal determination by the Court of Appeals that a withdrawable savings account in a savings and loan association is not a "security" within the meaning of the Securities and Exchange Act of 1934.

1. Nature of the Case and the Parties Involved.

This action is brought by certain holders of withdrawable capital accounts in the City Savings Association pursuant to Sections 10(b) and 29(b) of the Securities Exchange Act of 1934. 15 U.S.C. §§78j(b), 78cc (b) (1965). They have brought this action both on their own behalf and as a class action on behalf of all persons who opened withdrawable savings accounts between July 24, 1959, and June 26, 1964 (R. 2-5, 12) to rescind their opening of withdrawable accounts in City Savings. The Respondents here and defendants-appellants below are City Savings Association, its officers, directors, and certain officials of the State of Illinois. The association is now in the process of voluntary liquidation pursuant to a plan approved by its shareholders on July 28, 1964. The shareholders elected the respondents Louis Kwasman, Harry Hartman, and Dennis Kirby as liquidators to carry out the plan which was approved by the Department of Financial Institutions of Illinois as evidenced by a certificate filed with the Cook County Recorder of Deeds on August 7, 1964, the effective date of the plan.

When the complaint in this action was filed in the District Court, City Savings Association was in the custody of the respondent Joseph E. Knight, then Director of Financial Institutions of the State of Illinois. He had assumed custody on June 26, 1964, under authority granted to him by Section 848 Illinois Savings and Loan Act. (*Ill. Rev. Stats.* ch. 32, §848 (1963)). The respondent Justin Hulman was the Supervisor of the Savings and Loan Division of the Department of Financial Institutions.

Respondents, therefore, are mere *stakeholders*; they have no personal, financial interest in the outcome of this litigation. Petitioners, who admit that they are suing only on behalf of those persons who opened withdrawable savings accounts in City Savings after July 24, 1959 (Pet. Br. p. 4), are maintaining this action for only one purpose: in order to obtain a *priority* to the assets of City Savings Association.

Petitioner states that City Savings Association was granted under Illinois law "all general powers of a business corporation under the Illinois Business Corporation Act" (Pet. Br. p. 4). This is untrue. Under Illinois law a state chartered savings and loan association such as City Savings is controlled by the Illinois Savings and Loan Act. *Ill. Rev. Stats.* ch. 32, §§701-944 (1965). Section 708 of this Act provides that such an association has only those powers conferred on a corporation by the Business Corporation act that are reasonably incident to the accomplishment of the express powers conferred upon the association by the Illinois Savings and Loan Act. (*Ill. Rev. Stats.* ch. §708 (1965)).

2. Withdrawability of Capital Accounts.

Petitioners state that withdrawable savings accounts are by statute conditionally withdrawable and that they must be so "of necessity." (Pet. Br. p. 7.) They neglect to point out, however, that during the period petitioners had accounts in City Savings and until 1965, Illinois law provided that any amounts deposited after a condition as to withdrawability had been put into effect *must be fully withdrawable*. *Ill. Rev. Stats. Ch. 32, §773h (1963)*. City Savings Association did limit the amount which certain of its depositors could withdraw, and all of the petitioners opened their accounts *after* these limitations were put into effect. Thus none of the accounts of the petitioners were or could have been limited as to withdrawability.

3. Investment Powers of City Savings Association.

Petitioners have inaccurately stated the investment power of City Savings under Illinois law. They state that the management of an Illinois savings and loan association can invest capital "virtually without limitation." (Pet. Br. p. 10.)

On the contrary, Illinois law provides in great detail on what bases an association may loan funds to members. Loans may only be made on the security of withdrawable capital or of real estate. *Ill. Rev. Stats. Ch. 32, §791 (a), (b) (1965)*. If the security is real estate, Illinois law specifies restrictions to ensure that the security will be both good and adequate. *Ill. Rev. Stats. Ch. 32, §791 (b) (1)-(b) (5) (1965)*.

4. Respondents' Motion to Dismiss.

After briefs were filed by the parties, respondents' motion to dismiss the complaint was denied by the District Court on January 17, 1966 (R. 17). Petitioners filed their answer on February 3, 1966 (R. 17-29).

5. Petitioners' Motion for the Appointment of a Receiver.

Thereafter, petitioners moved for the appointment of a receiver of the assets of City Savings Association. After the question had been exhaustively briefed by the parties, including the SEC, the Court, on March 22, 1966, entered its order denying petitioners' motion for the appointment of a receiver (R. 29-33). In this order, the Court included the required certificate authorizing a petition for an interlocutory appeal under Section 1292(b) (R. 31). The District Court certified that its order holding that withdrawable capital shares in a savings and loan association are securities within the meaning of the Securities Exchange Act "... involves a controlling question of law as to which there is substantial ground for difference of opinion and that an immediate appeal from the order may materially advance the ultimate termination of the litigation." (R. 32.) Respondents did not seek leave to appeal from the order denying their request for the appointment of a receiver.

6. Opinion of the Court of Appeals.

Respondents' petition for leave to appeal was granted by the United States Court of Appeals for the Seventh Circuit on April 25, 1966. On January 20, 1967, after extensive briefs were filed by the parties and after oral argument, the Court of Appeals reversed the order of the District Court denying respondents' motion to dismiss (R. 43-64). Petition for a writ of certiorari was filed on April 20, 1967, and was granted on June 5, 1967 (R. 66).

SUMMARY OF ARGUMENT.

The holding of the Court of Appeals that a withdrawable capital account of an Illinois-chartered savings and loan association is not a "security" under the Securities Exchange Act of 1934 was correct. Both the language and the legislative history of the 1934 Act show that a withdrawable capital account in a savings and loan association is not a "security" under that Act. The term "security" was meant to apply to negotiable shares for which a more or less fluctuating market exists. Withdrawable capital accounts are, on the other hand, non-negotiable, fully matured at issue, fully withdrawable, and not subject to a fluctuating market.

The exemption of state savings and loan associations from the provisions of the Federal Bankruptcy Act, as well as the 1966 Amendments to the Federal Savings and Loan Insurance Corporation Act, which carefully preserve the role of the states in regulating local financial institutions, show the intent of Congress to limit federal regulation of state savings and loan associations. Congress has vested sufficient federal regulation of these associations in the Federal Home Loan Bank Board, and the imposition of SEC regulation over their activities by judicial fiat would produce a meaningless clash of regulatory orders and actions. Moreover, the SEC has not historically considered withdrawable capital accounts in savings and loan associations "securities" under the 1934 Act.

No case in this or any other jurisdiction has dealt with the issue presented by this case. The prior decisions of this Court, however, compel the conclusion that a withdrawable capital account is not a "security." Prior court decisions indicate that to be a "security" under the 1934 Act, an interest must involve (1) an investment of money in a

common enterprise (2) a fluctuating value, and (3) profits to come solely from the efforts of others. Withdrawable savings accounts do not involve an "investment of money" but rather involve a debtor-creditor relationship. The value of withdrawable savings accounts does not significantly fluctuate. Moreover, the profits accruing to a withdrawable savings account in a savings and loan association do not come "solely from the efforts of others." Instead, the profits come almost solely from the activities of the members among themselves, since both depositors and borrowers must be members of the association.

In addition, a holding that withdrawable savings accounts are securities would secure for petitioners a preference to the assets of City Savings Association and would discriminate against other holders of withdrawable capital accounts in the association. The basic unfairness of such a result further compels the conclusion that a withdrawable capital account is not a "security."

ARGUMENT

I.

CONGRESS DID NOT INTEND SAVINGS AND LOAN WITHDRAWABLE CAPITAL ACCOUNTS TO BE COVERED BY THE SECURITIES EXCHANGE ACT OF 1934.

Petitioners, by bringing this action, seek to rescind and have declared void their deposits in withdrawable capital accounts of City Savings and Loan Association, an Illinois chartered savings and loan association. By alleging that their deposits were solicited in violation of Section 10(b) of the 1934 Act and Rule 10 B-5 of the SEC, petitioners are trying to secure a *preference* for themselves as to the assets of City Savings and Loan Association.

The Act and the SEC rule apply, however, only to the purchase or sale of a "security." The question whether there has been any violation of the Act or of the SEC rule depends, therefore, upon whether the withdrawable capital accounts of City Savings Association are "securities."

The Act contains its own definition of the term "security." Because no case has considered whether a withdrawable capital account in a state-chartered savings and loan association is a security, that question must be answered by a reading of the statutory definition, together with other expressions of Congressional intent.

A. Withdrawable Capital Accounts Are Neither "Stock", Nor a "Certificate of Interest in a Profit Sharing Agreement", Nor a "Transferable Share", Nor an "Investment Contract".

1. Withdrawable Accounts are Not "Stock."

In concluding that withdrawable capital accounts are "stock," petitioners cite several provisions of the Illinois Savings and Loan Act to show that withdrawable capital accounts have characteristics similar to those of stock (Pet. Br. pp. 17-18). Petitioner does not mention, however, the many characteristics of such withdrawable accounts under Illinois law which distinguish them from "stock." These characteristics may be summarized as follows:

7 1. Withdrawable capital accounts may be issued in unlimited amounts. *Ill. Rev. Stat.*, ch. 32, §728 (5) (1965). By comparison, permanent reserve shares must have a par value and a limitation upon the amount which can be issued. *Ill. Rev. Stat.*, ch. 32, §728 (6) (1965).

2. Withdrawable capital accounts are not subject to the securities article of the Uniform Commercial Code. *Ill. Rev. Stat.*, ch. 32 §768 (c) (1965).

3. Withdrawable capital accounts are not negotiable and may be transferred only by assignment. *Ill. Rev. Stat.*, ch. 32, §768 (b), (c) (1965).

4. Withdrawable capital accounts are subject to forced redemption and retirement at any time upon the call of the Board of Directors. *Ill. Rev. Stat.*, ch. 32 §775(a) (1965).

5. Withdrawable capital accounts are fully matured and completely withdrawable at the time they are issued. *Ill. Rev. Stat.*, ch. 32 §§762(a) and 773(a) (1965). Permanent

reserve shares, of course, are not withdrawable. *Ill. Rev. Stat.*, ch. 32, §763(a) (1965).

6. Withdrawable capital accounts have no preemptive rights.

7. Withdrawable capital accounts are evidenced by a certificate or account book. *Ill. Rev. Stat.*, ch. 32, §768(a) (1965).

8. Holders of withdrawable capital accounts are not entitled to inspect the general books and records of the association. *Ill. Rev. Stat.*, ch. 32, §748 (1965).

9. No annual or other report is furnished to depositors, although an annual report must be published in at least one newspaper. *Ill. Rev. Stat.*, ch. 32, §844 (c) (1965).

Thus withdrawable capital accounts have an overwhelming number of characteristics that distinguish them from "stock." On the contrary, these interests are most closely akin to the characteristics of the familiar savings bank deposit. The holder of a withdrawable account has made a deposit of money in the savings and loan association and the amount of his deposit is recorded in his savings book.

Whenever the question of whether withdrawable savings accounts are "stock" has been directly considered, a distinction between these two concepts has been recognized. For example, Prather in *Savings Accounts* (1959) at p. 38 states:

"Throughout the United States it has been held that ownership of accounts in savings associations constitutes not the ownership of 'shares of stock' but a relationship unique unto itself, a relationship more nearly comparable to that established between a bank and its depositor. The relationship is a contractual right, enforceable by law, to have the money

which has been placed in the association repaid to the saver according to the terms of the savings contract."

Many cases have expressly recognized that withdrawable savings accounts are not the same as corporate stock. See *In re Krueger's Estate*, 180 Wash. 165, 39 P.2d 381, 383 (1934) ("While the members were technically stockholders in common acceptations these savings were deposits rather than investments in corporate stock."); *Bell v. Bakerstown Savings Association*, 385 Pa. 158, 122 A.2d 411, 413 (1956) ("The savings account is analogous to a bank account."); *Rummens v. Home Savings Association*, 182 Wash. 539, 47 P.2d 845, 846 (1935) ("While the members of savings and loan associations may sometimes be referred to as stockholders, they are depositors rather than investors in corporate stock."); *In re Mulkins and Crawford Electric Co.*, 145 F. Supp. 146, 147 (S.D. Cal. 1956) ("It is clear that the legislature intended to give exclusive meanings to each of the terms 'shares' and 'stocks' as used in § 6400, and it cannot be questioned that under the Savings and Loan Association's Law a marked distinction is made between 'withdrawable accumulative shares' and 'stock' ... The shares here in question are not stock.")¹

¹Although it is true that in *Marshall Savings and Association v. Henson*, 78 Ill. App. 2d 14, 222 NE2d 255 (1966), the Appellate Court of Illinois called holders of withdrawable capital accounts in a savings and loan association "shareholders" (Pet. Br. Note 13, pp. 20-21), the offhand remark of the court by no means constituted an adjudication of the matter.

Petitioners also cite *Bowman v. Armour and Co.*, 17 Ill. 2d 43, 160 NE2d 753 (1959), in support of their contention that withdrawable capital accounts are stock. This case is not on point, however, since the Illinois court was not there required to make a distinction between corporate stock and withdrawable savings accounts either

2. Withdrawable Accounts are not "Transferable Shares", "Investment Contracts", or "Certificates of Interest in a Profit Sharing Plan".

Petitioners and the SEC also contend that the withdrawable capital accounts of City Savings Association are securities under the 1934 Act because they are "transferable shares" or "investment contracts" or "certificates of interest or participation in any profit sharing agreement." (Pet. Br. pp. 21-23; SEC Br. pp. 11-13). Petitioners cite Loss, *Securities Regulation* (2d ed. 1961) for the proposition that these instruments include interests in fishing boats, automobile trailers, vending machines, cemetery lots, tung trees, vineyards, fig orchards, farmland, etc. Petitioners have failed to advise the Court, however, that Loss' statement is preceded by an explanation that these transactions were based upon "a purported sale or lease of some farm of tangible property subject to an arrangement whereby the seller retains possession and control of the property with a view to earning a profit for the nominal owners and lessees." Loss, *Securities Regulation*, 489-90 (2d ed. 1961). This significant characteristic distinguishes these transactions as well as the case of *SEC v. Los Angeles Trust, Deed and Mortgage Exchange*, 285 F.2d 162 (9th Cir. 1960) (SEC Br. Note 15 p. 21). Such transactions differ radically from a withdrawable capital account in a savings and loan association. In the first place, no interest in tangible property, personal or real, is transferred to a holder of a withdraw-

generally or for the purposes of the Securities Exchange Act of 1934.

The case of *Gidwitz v. Lanzit Corrugated Box Company*, 20 Ill. 2d 208, 170 NE2d 131 (1960), which is also cited by the petitioners, is equally irrelevant. The court was not there considering any question pertaining to savings and loan associations or to withdrawable capital accounts.

able account. There is no "sale or lease" whereby the seller retains possession and control of the property. Secondly, the "property" transferred had itself a fluctuating market value, thereby giving a fluctuating value to the instruments representing interests in that specific property. Thus, the land involved in the tung tree plantation carried a variable price, and the investor in an interest in such a plantation was led to expect that this fluctuation in price would work to his benefit. By way of contrast, the underlying properties involved in savings and loan associations are merely loans, carrying a stated face value and rate of interest, to be repaid either in a lump sum or periodically. The loan is secured by a first mortgage of real estate. The association is not speculating on an increase in the value of the real estate and the withdrawable account cannot fluctuate in value. Thus the element of speculation, which is present in all transactions enumerated by Professor Loss, is not present in the savings and loan association withdrawable accounts.

Petitioners again cite several provisions of the Illinois Savings and Loan Act to show that withdrawable capital accounts have characteristics of certificates of interest in a profit sharing agreement, transferable shares, and investment contracts (Pet. Br. pp. 21-22). Once again, however, petitioners omit mentioning the many characteristics of withdrawable capital accounts that under the Illinois Savings and Loan Act distinguish these interests from certificates of interest in a profit sharing agreement, transferable shares, and investment contracts. Withdrawable accounts are not negotiable. *Ill. Rev. Stat. ch. 32, §768 (b), (c) (1965)*. This prevents these interests from having a market in which they may be traded or in which speculation might occur. Withdrawable accounts may be issued in unlimited amounts. *Ill. Rev. Stat. ch. 32, §728 (5) (1965)*.

This characteristic precludes the maintenance of a market for them. Withdrawable accounts are also fully matured and completely withdrawable at the time they are issued. *Ill. Rev. Stat.* ch. 32, §§762 (a) and 773 (a) (1965).

B. A Withdrawable Capital Account Is Not an "Instrument Commonly Known as a 'Security'."

The legislative history of the Securities Act of 1933, which defines a "security" in substantially the same way as does the 1934 Act, indicates that Congress intended the term "security" to mean those instruments usually thought of as securities. The Report accompanying the Securities Act of 1933 states:

"Paragraph (1) defines the term 'security' in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the *ordinary* concept of a security." H.R. Rep., No. 85, 73rd Cong., 1st sess. 2-4 (1933), p. 11. (Emphasis added.)

The chief characteristics of a withdrawable account as enumerated above on pages 7 and 8 show that these interests are very different from interests commonly known as securities. On the contrary, withdrawable accounts are most commonly thought of as akin to bank savings deposits.

The Illinois Legislature in creating withdrawable accounts in savings and loan associations, did not consider or intend such accounts to be securities. The Illinois Savings and Loan Act provides that:

"Withdrawable capital certificates, account books, and any other evidences of membership shall be non-negotiable and not subject to Article 8 of the Uniform Commercial Code concerning investment securities." *Ill. Rev. Stats.*, ch. 32, §768 (c) (1965).

The statute specifically provides that permanent reserve shares are subject to Article 8 of the Uniform Commercial Code. *Ill. Rev. Stat.*, ch. 32, §768 (c) (1965).

While this statute may not be conclusive in determining whether withdrawable capital accounts are securities under Federal law, it does give a characteristic to withdrawable accounts which must be considered in determining whether they are similar to instruments commonly known as securities. In the face of such a statute, withdrawable capital accounts could never be "commonly known as a security" as required by the 1934 Act, 15 U.S.C. §78c (a) (10) (1965).

The preamble of the Securities Exchange Act of 1934 provides additional evidence of a Congressional intent to exclude withdrawable savings and loan accounts from its provisions. The Act was designed to regulate:

"transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets . . . (when) the prices of securities on such exchanges and markets are susceptible to manipulation and control, and the dissemination of such prices gives rise to excessive speculation resulting in sudden and unreasonable fluctuations in the prices of securities. . . ." Securities Exchange Act of 1934, §2, 15 U.S.C. §78b (1965).

This clear expression of Congressional intent indicates that the Act was designed to cover only those securities which are negotiable and for which a fluctuating market exists. Since a withdrawable account in an Illinois savings and loan association is by statute made non-negotiable, no fluctuating or other market exists for savings accounts, and they are not traded either on an exchange or on the over-the-counter market. Thus, to hold a withdrawable savings account to be a security would be to go beyond the purpose of the 1934 Act as expressed in its preamble.

An essential characteristic of a withdrawable account in a savings and loan association is its withdrawability and complete maturity from the moment of its creation. An investor is free to withdraw his investment at any time. The Illinois Savings and Loan Act specifically provides:

"A holder of withdrawable capital may make application for withdrawal of, and the association may pay, all or any part of the withdrawal value thereof at any time." *Ill. Rev. Stats.*, ch. 32, §773 (a) (1965)²

The immediate withdrawability of accounts in a savings and loan association as well as their complete maturity at the time of their creation, compels the conclusion that the 1934 Act is not applicable to them, since no additional protection would be given to investors by application of the Act.

The intention of Congress to exclude withdrawable savings and loan accounts from the purview of the 1934 Act is further manifested by the express exclusion from the definition of a "security" of debtor-creditor relationships, represented by instruments such as notes which mature within nine months from the date of their insurance. Since a withdrawable capital account is fully withdrawable and thus mature at issue, *Ill. Rev. Stats.*, ch. 32, §762 (a) (1965), there is a close similarity between it and a debtor-creditor

² The Illinois Savings and Loan Act at one time allowed an association to place limits on the amount which a holder of a withdrawable account could withdraw at one time. *Ill. Rev. Stats.*, ch. 32, §773 (b) (1965). However, any amounts deposited after such a limitation was placed in effect had to be fully withdrawable. *Ill. Rev. Stats.*, ch. 32, §773(h) (1963). Although City Savings Association did limit the amount which certain of its depositors could withdraw, none of the petitioners, all of whom deposited after such limitation was placed into effect, could legally be limited as to withdrawability of his account. This section was repealed in 1965.

relationship which matures within nine months from issue. Thus, these accounts fit within a category which Congress clearly exempted from the provisions of the Act. See *Harn v. Woodard*, 151 Ind. 132, 50 N.E. 33 (1898), which holds that the holder of a withdrawable account in a saving and loan association is in a debtor-creditor relationship with the association.

Petitioners contend that because of the wording of the exemption in the Illinois Securities Act, *Ill. Rev. Stat.*, ch. 121½, §137.3 (1965) Illinois recognizes that building and loan withdrawable capital accounts are securities. (Pet. Br. pp. 29-32) Petitioners' reasoning becomes valid only if it can be shown that the exemptions in Section 137.3 were intended to be definitional in character. Evidence that such was not the case can be found by reading sub-section I, J and L of the same exemption Section, which exempt real estate purchase contracts, notes secured by first mortgages, and negotiable notes, drafts and bankers acceptances arising out of current transactions. (The complete text of the exemptions, together with the definition of "security" under the Illinois Act, is set forth in the Appendix.) If read as petitioners would have us read this section, the absurd result would be that Congress declared those instruments enumerated in sub-sections I, J and L to be securities by "exempting" them, for in the absence of the exemption, no one could possibly contend that those instruments were "securities" within the meaning of that term as defined in §137.2-1. The only conclusion is that §137.3 was not intended to *define* what instruments are securities, but was intended to clarify what instruments were not subject to the Act, regardless of whether they were securities in the first instance under the definition of that term in Section 137.2-1.

The same can be said of petitioners' argument (Pet. Br. pp. 36-38) that the exemption from the registration provisions of Section 12 of the Securities Exchange Act of 1934 (added in 1964) indicates a Congressional intent to include withdrawable capital accounts within the definition of security found in Section 3(a) (10), 15 U.S.C. §78c(a) (10) (1965). As Professor Loss has stated, in discussing an analogous exemption, "it would be too facile to argue" that an exemption in an SEC rule for those real estate brokers who sell "no securities except shares of cooperative apartment corporations proves conclusively that such shares (cooperative apartment corporations) are securities under either the 1933 Act or the 1934 Act." *Loss, Securities Regulation*, 493-94 (2d ed. 1961). (Emphasis added.) Similarly, the exemption in Section 3(a) (8) of the Securities Act for "any insurance or endowment policy or annuity contract" although creating a negative implication that insurance policies are securities, which may be exempt from the registration requirement but are subject to the anti-fraud provision" [*Loss, Securities Regulation*, 497 (2d ed. 1961)] has been interpreted by the SEC as not implying that insurance contracts are securities. See Hearings before Subcom. of Senate Com. on Banking and Currency on S. 2408, 81st Cong., 2d Sess. 33 (1950); *Loss, Securities Regulation*, 497 (2d ed. 1961).³ See also

³ The House Report on this section of the 1933 Act stated:

"Paragraph (8) makes clear what is already implied in the act, namely, that insurance policies are not to be regarded as securities subject to the provisions of the act. The insurance policy and like contracts are not regarded in the commercial world as securities offered to the public for investment purposes. The entire tenor of the act would lead, even without this specific exemption, to the exclusion of insurance policies from the provisions of the act, but the specific exemption is included to make misinterpretation impossible." H. Rep. 85, 73rd Cong., 1st Sess., p. 15 (1933).

SEC v. Variable Annuity Life Ins. Co., 359 U.S. 65, 74 n. 4 (1959) (concurring opinion). Similarly untenable is the argument that the exemption from the 1933 Act in Section 3(a) (5) for "any security" issued by a building and loan association proves that all building and loan share accounts are securities within the meaning of the definition Section, §2(1).

Petitioners also cite the Investment of Public Funds Act, *Ill. Rev. Stat.* ch. 102, §30 (1965), the State Treasurer Act, *Ill. Rev. Stat.* ch. 130, §41(a) (1965), and the Credit Union Act, *Ill. Rev. Stat.* ch. 32, §496.23 (1965) for the proposition that withdrawable capital accounts are securities under Illinois law (Pet. Br. pp. 32-33). These acts are plainly irrelevant to the issue at bar. When these acts were passed, the Illinois legislature did not at all consider the question in this case, and the sections cited by petitioners are not definitional in character.

The provisions of the Illinois Insurance Code, *Ill. Rev. Stat.* ch. 73, §§737.14(a), 792.1, and 953 (1965) and the Illinois Probate Act, *Ill. Rev. Stat.* ch. 3, §259(e) (1965) (Pet. Br. pp. 33-34) are irrelevant for these reasons also. Moreover, one of the provisions of the Illinois Insurance Code cited by petitioners does posit a distinction between shares and accounts or deposits in a savings and loan association. *Ill. Rev. Stat.* ch. 73, §737.14(a) (1965).

C. Congress Intended to Limit Federal Regulation of State Savings and Loan Associations.

One of the concerns of Congress in enacting legislation affecting financial institutions has been to preserve and maintain the dual system of banking in the United States. Thus, under the Federal Bankruptcy Act, state building and loan associations are exempt from federal bankruptcy

adjudication. 11 U.S.C. §22 (1965). The reason for this exemption is the fear of disrupting state administration and intruding into an area of state concern. The report of the House Judiciary Committee states this clearly:

“Building and Loan Associations are of a peculiar nature, . . . functioning almost exclusively in local communities. The deposits received are from local depositors and the securities taken are local securities. Therefore, it seems the part of wisdom to leave the administration of these matters in the local courts.” Rep. 98, 72d Congress, 1st Session, House Judiciary Committee; House Reports 2-659; as quoted with approval in *Security Building and Loan Association v. Spurlock*, 65 F. 2d 768, 771 (9th Cir. 1933).

The report of the Senate Judiciary Committee on the bill concurs as to the policy behind the exemption for building and loan associations:

“The purpose of it is to make clear that building and loan associations do not come within the provisions of the bankruptcy act. . . . This amendment puts the building [and] loan [associations] in the same class with municipal, railroad, insurance and banking corporations.” Senate Reports, 2-574, 72d Congress, 1st Session as quoted in *Security Building and Loan Association v. Spurlock*, 65 F.2d 768, 771 (9th Cir. 1933).

Since City Savings Association derives its existence and powers from the Illinois Savings and Loan Act, it would be exempt from the provision of the Bankruptcy Act. *Home Savings and Loan Association v. Plass*, 57 F.2d 117 (9th Cir. 1932). The intention of Congress is to leave the regulation of these associations up to the states.

In 1966, when the powers of the Federal Savings and Loan Insurance Corporation were greatly broadened, Congress was careful to preserve the role of the states in regulating local financial institutions. After providing

that any civil suit to which the FSLIC shall be a party shall be deemed to arise under the laws of the United States, the following proviso was added:

"Provided, That any action, suit, or proceeding to which the Corporation is a party in its capacity as conservator, receiver, or other legal custodian of an insured State-chartered institution and which involves only the rights or obligations of investors, creditors, stockholders, and such institution under State law shall not be deemed to arise under the laws of the United States." 12 U.S.C.A. §1730 (k) (1) (1965).

The legislative history of this Act shows that this proviso was added because of the concern of Congress about the effect of the bill on the dual banking system of the United States. The Senate Report states as follows:

"In addition to the protection against arbitrary and oppressive action which this provides for the benefit of the institutions and individuals affected, this provision constitutes a significant recognition in Federal statutes of the importance of the powers and responsibilities of the State supervisory authorities in our dual financial systems."

"The committee considers that the bill emphasizes the role of the state chartering and supervisory authorities, and in no way lessens the status of these State authorities." 10 U.S. Code Cong. and Ad. News 4284-4285 (1966).

In his concurring opinion in *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959), Mr. Justice Brennan pointed out that when it can be found that Congress has left substantial responsibility for regulation to the states and that the regulatory functions assigned to the federal government cannot be accomplished by holding the interests involved to be securities, then the Securities Act should not apply. As is the case with insurance com-

panies, the State of Illinois assumes a major rôle in the regulation of the operation of savings and loan associations.⁴ There is thus no need for additional federal regulation.

Were savings and loan withdrawable capital accounts held to be "securities", the regulation and administration of savings and loan associations would almost inevitably become a matter of Federal jurisdiction. In a proper case, the liquidation of insolvent savings and loan associations through Federal equity receiverships would follow, despite the clear expression of Congressional intent to the contrary. This has been the case with the liquidation of securities brokers. *SEC v. H. S. Simmons and Company*, 190 F. Supp. 432 (S.D.N.Y. 1961). A motion for the appointment of a receiver for the assets of City Savings was made in the trial court below. After the matter had been exhaustively briefed, the court below denied the motion. It is respectfully submitted that not until the application

⁴ For example, in Illinois the investments made by a savings and loan association are strictly limited by statute. *Ill. Rev. Stat.*, ch. 32, §§791 through 804 (1965). Directors or officers who knowingly make or plan an unauthorized investment are individually liable for all consequential damages to the depositors. *Ill. Rev. Stat.*, ch. 32, §902 (1965). The Commissioner of Savings and Loan Associations is given supervisory power over state chartered savings and loan associations. He is required to cause a surprise examination of every association annually and is empowered to compel compliance with recommended corrective measures. *Ill. Rev. Stat.*, ch. 32, §842 (1965). Under certain circumstances, the Commissioner is empowered to take custody of any association which has refused to take corrective action or which has impaired its withdrawable capital or which is being conducted in a fraudulent, illegal or unsafe manner. *Ill. Rev. Stat.*, ch. 32, §848 (1965). The Commissioner does not relinquish custody until the causes for his taking custody have been removed. *Ill. Rev. Stat.*, ch. 32, §854 (1965).

was made for the appointment of a receiver did the trial court below realize fully the ramifications of holding withdrawable capital accounts to be securities, and the extent to which such a holding would frustrate the will of Congress, expressed in the Bankruptcy Act and elsewhere, that savings and loan associations be administered under local law. This led to the inclusion in the order denying the appointment of a receiver of language authorizing the interlocutory appeal on the question of the applicability of the Securities Exchange Act of 1934 to these accounts.

D. Congress Has Vested Federal Regulation of State Savings and Loan Associations in the Federal Home Loan Bank Board.

The SEC seems to believe that the decision of the Court of Appeals in this case precludes federal regulation of the savings and loan industry and leaves the holders of withdrawable capital accounts unprotected. This is untrue. In stressing the need for regulating powers, the Commission ignores the elaborate scheme created by Congress to have the Federal Home Loan Bank Board perform this very function on the Federal level. (National Housing Act Title IV, §402(a) et seq.) 12 U.S.C. §1701 et seq. (1965). As of August 1, 1967, assets of all savings and loan associations in this country totaled \$138 billion dollars. Associations whose accounts were federally insured had assets of \$134,000,000,000. Uninsured associations had assets representing approximately 2.9% of the total.

The Federal Home Loan Bank Board directs a major regulatory agency with hundreds of employees including accountants, economists, and attorneys in the District of Columbia and in twelve regional districts throughout the country.

Congress gave the Board broad discretionary powers in terminating insurance of insured institutions or in prohibiting unsafe practices through cease and desist orders. This power may be exercised by the Board "whenever [in its opinion] any insured institution has violated its duty as such or is engaging or has engaged in an unsafe or unsound practice in conducting the business of such institution, or is in an unsafe or unsound condition to continue operations as an insured institution, or is violating or has violated applicable law, rule, regulation, or order, or any condition imposed in writing by the Corporation in connection with the granting of any application or other request by the institution, or any written agreement entered into with the Corporation, . . ." 12 U.S.C. §1730(b)(1) (1965).

In 1966, Congress gave the Board broad cease and desist powers and authorized it to remove or suspend directors and officers of insured institutions.

The Board is authorized to act as conservator or receiver of an insured state institution. The Board, if not receiver, may bid for the assets of the insured institution in default.

It is easily seen that Congress could not have intended that the Securities Exchange Commission should have jurisdiction over precisely the same matters. A contrary view would require an argument that Congress intended a meaningless clash of regulatory orders and actions.

E. Congress Intended to Regulate Only Those Instruments Which Have a Fluctuating Value and Which Are Traded on a Market.

Congress clearly and unequivocally stated its intent in Section 2 of the Act, which "section contains a general declaration of the purposes and objects of the bill." S.

Rep. No. 792, 73d Cong., 2d Sess., p. 14 (1932). (The entire text of Section 2 is set forth in the Appendix to this brief.) As a reading of this Section clearly reveals, Congress intended that only those securities which are negotiable and for which a fluctuating market exists should be subject to the provisions of the Securities Exchange Act of 1934.

Second, the historical context in which this legislation was enacted furnishes further evidence of the intent of Congress. As the Supreme Court has stated, "Courts in construing a statute, may with propriety recur to the history of the times when it was passed." *Great Northern Railway Co. v. United States*, 315 U.S. 262, 273 (1942). As reflected in §2 of the Act, the great crash of 1929, and the ensuing damage to the national economy, attributed by many to excessive speculation in securities with great fluctuation in the prices of securities, led Congress to enact this remedial legislation. Congress obviously was concerned with speculation in securities markets, whether conducted on national securities exchanges, or conducted in over-the-counter markets throughout the country. As stated in *SEC v. C. M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943):

"In the Securities Act the term 'security' was defined to include by name or description many documents in which there is *common trading for speculation or investment*." (Emphasis added.)

The House Committee on Interstate and Foreign Commerce also recognized the purpose of the 1934 Act:

"The statute provides for disclosure of information concerning securities listed on exchanges and for the regulation of *trading* in securities on exchanges and over-the-counter markets." H.R. Rep. No. 1418, 88th Cong., 2d Sess., 1964 U.S. Code Cong. & Ad. News at p. 3016. (Emphasis added.)

Whether Congress intended to subject withdrawable capital accounts to the Securities Exchange Act of 1934 can only be determined by examining the policy of that statute as compared with the characteristics of the withdrawable capital account. The chief characteristic of the account is its complete withdrawability. The holder of the account is free to obtain full payment at any time upon demand. All of the accounts issued to members of the class purportedly represented by petitioners enjoyed complete withdrawability of their accounts. The section of the Illinois Savings and Loan Act under which petitioners made their deposits provides:

"An association while operating under this Section may accept additional withdrawable capital from its present shareholders as well as accept new withdrawable capital accounts and such withdrawable capital accounts shall not be subject to the provisions of sub-section (b) of this Section, but shall be subject to withdrawal at will so long as the association is operating under the provisions of sub-section (b) of this Section." Illinois Savings and Loan Act, §4-14(h), *Ill. Rev. Stat. Ch. 32, §773(h)* (1963).

To avoid this argument, petitioners contend that the complaint alleges that their withdrawable capital accounts were on a limited withdrawal basis, in violation of this statute. Their complaint does not support their contention. More importantly, any such limitations were invalid, and petitioners' accounts were completely withdrawable in full. Any restrictions placed upon withdrawability would have violated the public policy expressed in the statute, would have been beyond the power of the directors to impose, and would have been completely void and of no effect. This is made abundantly clear in the case of *Latimer v. Equitable Loan and Investment Company*, 81 F. 776 (W.D. Mo. 1897), where the court stated:

"[A]ny contract by which the owner of corporate stock deprives himself of important rights secured to him by the statute, and which he acquires by virtue of his ownership of the stock under the statute, is void. . . . The statutory right of ending a stockholder's relation to a loan and building association, by withdrawal therefrom is a fundamental right, evidencing a public policy, which cannot be waived or contracted away by any one or more members of such association . . ." 81 F. at 780-82.

Again this is an issue of law, not fact, and accordingly is not admitted by a motion to dismiss. *Weeks v. Denver Tramway Corp.*, 108 F.2d 509 (10th Cir. 1939).

Withdrawable capital accounts are not traded either on exchanges or through the over-the-counter market and are thus outside the scope of intended Congressional regulation.

II.

THE SEC HAS NOT CONSIDERED WITHDRAWABLE CAPITAL ACCOUNTS AS SECURITIES UNDER THE 1934 ACT.

The legislative history of the 1964 amendments to the 1934 Act cited by the SEC (SEC Br. p. 25) shows that the SEC has always looked at withdrawable savings accounts as deposits in banks and therefore not subject to the Act. The SEC has further viewed such interests in the same light as insurance policies, which are clearly not securities under either the 1933 or 1934 Acts. (See Loss, *Securities Regulation* 497 (2d ed. 1961), and discussion at p. 18, *infra*). Mr. William L. Cary, then Chairman of the SEC testified as follows:

"With respect to savings and loan associations, an effort is made to treat them in essentially the same

manner as insurance companies are treated, that is, mutual savings and loan associations will be exempt, just as mutual insurance companies are:

"In the case of stock savings and loan associations, the stock, if purchased and traded as an equity investment, is subject to H.R. 6789 just as is stock of insurance companies.

"On the other hand, savings accounts in savings and loan associations are not subject to the bill, just as insurance policies are not covered. Because of the fact that most savings and loan associations issue so-called shares, which in fact merely evidence the existence of a savings account, special provision had to be made in proposed section 12(g) (2) (C) of the bill to exempt that type of 'share.'" Testimony of William L. Cary, Hearings on H.R. 6789, H.R. 6793, and S. 1642 before a Subcommittee of the House Committee on Interstate and Foreign Commerce, 88th Cong., 1st Sess., p. 1213, (1963).

Further evidence that the SEC has not considered withdrawable capital accounts securities is the fact that the SEC did not deal with them at all in its comprehensive Special Study of the Securities Markets, completed in 1963.

The case and rulings cited by the SEC for the proposition that the Commission has held withdrawable capital accounts to be securities under the 1934 Act are wholly inapplicable. The case of *Archer v. SEC*, 133 F2d 795 (8th Cir. 1943) cert. denied 319 U.S. 767 (1944) involved more than savings and loan association "certificates"; the court's holding that section 17(a) of the 1933 Act and section 15(c)(1) of the 1934 Act had been violated was also based on fraudulent sales of common stock. Moreover, there is no indication that the court in that case was presented with the question of whether withdrawable sav-

ings accounts are securities. Obviously, the court never intended to deal with that question.

III.

PRIOR COURT DECISIONS COMPEL THE CONCLUSION THAT A WITHDRAWABLE CAPITAL ACCOUNT IS NOT A SECURITY.

This Court has not decided the question of what constitutes a "security" within the meaning of that term as defined in the Securities Exchange Act of 1934. However, it has decided questions under the Securities Act of 1933, which presumably give guidelines for resolving the question presented by this case. In discussing whether assignments of oil leases were securities under the 1933 Act this Court stated: "... In the Securities Act the term 'security' was defined to include by name or description many documents in which there is *common trading for speculation or investment*." *SEC v. C. M. Joiner Leasing Corp.*, 320 U.S. 344, 351 (1943) (Emphasis added.) In *SEC v. W. J. Howey Co.*, 328 U.S. 293, 301 (1946), this Court stated its view of the law in this area even more clearly: "The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."

There are three requirements, therefore, for an instrument to be a security within the 1934 Act: (1) There must be an investment of money in a common enterprise; (2) there must be profits derived solely from the efforts of others; and (3) there must be common trading for speculation or investment. All of these elements are missing from the withdrawable capital accounts of savings and loan associations.

In the first place, a deposit in a withdrawable savings account is not an investment but actually creates a debtor-creditor relationship. *Harn v. Woodard*, 151 Ind. 132, 50 N.E. 33 (1898). The depositor loans his money to the association with the knowledge that it is withdrawable at will and in the expectation that his deposit will earn interest. While the Illinois courts have not definitely adjudicated this relationship, numerous other jurisdictions confirm that the relationship is one of debtor and creditor. See *In re Krueger's Estate*, 180 Wash. 165, 39 P.2d 381, 383 (1934); *Bell v. Bakerstown Savings Assn.*, 385 Pa. 158, 122 A.2d 411, 413 (1956); *Rummens v. Home Savings Assn.*, 182 Wash. 539, 47 P.2d 845, 846 (1935). Thus the relationship in the instant case is more closely analogous to one of debtor-creditor and *not* one of investment. The Court below correctly found that the "investment in a common enterprise" test of this Court was not met. *Tcherepnin v. Knight*, 371 F.2d 374, 377 (7th Cir. 1967).

In the second place, profit is not derived "solely from the efforts of others." Money that is deposited is loaned to other members of the savings and loan association. Depositors and borrowers must be members of the association. *Ill. Rev. Stat.*, ch. 32, §741 (1965). Thus, the profits of the enterprise result from the activities of members among themselves. Outsiders do not have any but the smallest dealings with the association. The Court below expressly recognized the failure of withdrawable capital accounts to meet this test. *Tcherepnin v. Knight*, 371 F.2d 374, 377 (7th Cir. 1967).

Finally, the *Joiner* case sets up the requirement that there be common trading for speculation or investment for an instrument to be a security. Because of the non-negotiable character and fixed-amount obligation of withdrawable ac-

counts, there is no common trading for speculation or investment in the withdrawable capital accounts of City Savings Association.

This fundamental requirement of trading in interests having a fluctuatory value was recognized in *SEC v. Variable Annuity Life Ins. Co.*, 359 U.S. 65 (1959). There, variable annuity contracts, whose return was not fixed but whose return was measured by the success or failure of the investment policy of the annuity company, were held to be securities. As Mr. Justice Brennan emphasized in his concurring opinion, Congress intended to regulate only those interests which had a fluctuating value and whose return to the investor was measured by the success or failure of the investment company's experience.

This characteristic of a security was again recognized in *SEC v. United Benefit Life Ins. Co.*, 387 U.S. 202 (1967). There, this Court held a "Flexible Fund Annuity" to be a security which cannot be offered to the public without conformity to the registration requirements of Section 5 of the 1933 Act. This Court emphasized that this instrument is a security because its appeal to the purchaser is on the basis of "growth", not of stability and security. (387 U.S. 202, 211). It is evident that to depositors in a savings and loan association, withdrawable capital accounts represent not so much growth as stability and security.

Of course, petitioners here are bearing the risk of insolvency of the Association. However, as Mr. Justice Brennan pointed out, the Federal Securities Acts are not designed to protect against this risk:

"Even more unpersuasive is the respondents' argument that even in a traditional annuity the policyholder bears the investment risk in the sense that he stands the risk of the company's insolvency. The prevention of insolvency and the maintenance of 'sound' financial

condition in terms of fixed-dollar obligations is precisely what traditional state regulation is aimed at." *SEC. v. Variable Annuity Life Ins. Co.*, 359 U.S. 65, 90-91 (1959).

And as further pointed out by Mr. Justice Harlan in his dissenting opinion in the *Variable Annuity* case, savings bank deposits were equated by Congress with insurance policies and neither were intended to be subject to the Securities Exchange Act of 1934. (359 U.S. at 98-99.)

IV.

A HOLDING THAT WITHDRAWABLE SAVINGS ACCOUNTS ARE "SECURITIES" WOULD SECURE FOR PETITIONERS A PREFERENCE TO THE ASSETS OF CITY SAVINGS ASSOCIATION AND WOULD DISCRIMINATE AGAINST OTHER HOLDERS OF WITHDRAWABLE ACCOUNTS IN THE ASSOCIATION.

In the case at bar, petitioners purport to represent a class composed of persons who made deposits in City Savings Association after July 23, 1959. Petitioners exclude from this class all the many depositors who opened accounts in City Savings Association prior to this time. The accounts of nearly all of these prior depositors had been placed on a limited withdrawability basis. Prior to July 9, 1959, an association whose accounts had been placed on a limited withdrawability basis could not accept new deposits. However, by an Act which became effective on July 9, 1959 such an association could accept new deposits provided that no limitation as to withdrawability would be placed on such new deposits. *Ill. Rev. Stat.*, ch. 32 §773(h) (1963). (Effective August 1, 1965, the Illinois General Assembly repealed this section.) All of the persons pur-

portedly represented by petitioners made their deposits under this act, and thus all of petitioners' accounts were fully withdrawable. Petitioners seek to have their deposits declared void, to be declared creditors of the Association, and to enjoin the payment of any liquidation proceeds to pre-July 23, 1959 depositors until after petitioners have been repaid in full. The purpose of labeling as "securities" petitioners' accounts, while refusing to classify accounts opened prior to July 23, 1959 as securities, is to give petitioners a priority over the other depositors in the association solely because of the time when the deposits were made.

This issue as to the applicability of the Securities and Exchange Act of 1934 raised by petitioners could arise only in a situation where a preference in liquidation of an uninsured savings and loan association is claimed. If the 1934 Act were to apply, the statute of limitations under the 1934 Act would apply also. This provides that actions under the 1934 Act must be brought within three years after the accrual of the cause of action and within one year of the discovery of the facts constituting the cause of action. 15 U.S.C. §78cc(b) (1965). Thus in every case of the liquidation of an uninsured savings and loan association, there would be a danger that the more recent depositors could obtain a preference over the earlier depositors, if withdrawable savings accounts are held to be securities.

No justification exists for the granting of such a preference in this case or indeed in any case. This alone compels the conclusion that Congress did not intend that a withdrawable savings account should be a security.

CONCLUSION

For the reasons stated above, these Respondents respectfully pray that the decision of the Court of Appeals be affirmed.

Respectfully submitted,

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APPENDIX

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Securities Exchange Act of 1934, §2, 48 Stat. 881, 15 U.S.C. §78(b) (1964):

“For the reasons hereinafter enumerated, transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets are affected with a national public interest which makes it necessary to provide for regulation and control of such transactions and of practices and matters related thereto, including transactions by officers, directors, and principal security holders, to require appropriate reports, and to impose requirements necessary to make such regulation and control reasonably complete and effective, in order to protect interstate commerce, the national credit, the Federal taxing power, to protect and make more effective the national banking system and Federal Reserve System, and to insure the maintenance of fair and honest markets in such transactions.

“(1) Such transactions (a) are carried on in large volume by the public generally and in large part originate outside the States in which the exchanges and over-the-counter markets are located, and/or are effected by means of the mails and instrumentalities of interstate commerce; (b) constitute an important part of the current of interstate commerce; (c) involve in large part the securities of issuers engaged in interstate commerce; (d) involve the use of credit, directly affect the financing of trade, industry, and transportation in interstate commerce, and directly affect and influence the volume of interstate commerce; and affect the national credit.

“(2) The prices established and offered in such transactions are generally disseminated and quoted throughout the United States and foreign countries and constitute a basis for determining and establishing the prices at which securities are bought and sold, the

amount of certain taxes owing to the United States and to the several States by owners, buyers, and sellers of securities, and the value of collateral for bank loans.

“(3) Frequently the prices of securities on such exchanges and markets are susceptible to manipulation and control, and the dissemination of such prices gives rise to excessive speculation, resulting in sudden and unreasonable fluctuations in the prices of securities which (a) cause alternately unreasonable expansion and unreasonable contraction of the volume of credit available for trade, transportation, and industry in interstate commerce, (b) hinder the proper appraisal of the value of securities and thus prevent a fair calculation of taxes owing to the United States and to the several States by owners, buyers, and sellers of securities, and (c) prevent the fair valuation of collateral for bank loans and/or obstruct the effective operation of the national banking system and Federal Reserve System.

“(4) National emergencies, which produce widespread unemployment and the dislocation of trade, transportation, and industry, and which burden interstate commerce and adversely affect the general welfare, are precipitated, intensified, and prolonged by manipulation and sudden and unreasonable fluctuations of security prices and by excessive speculation on such exchanges and markets, and to meet such emergencies the Federal Government is put to such great expense as to burden the national credit.” Securities Exchange Act of 1934, §2, 15 U.S.C. §78(b) (1964).¹

The Illinois Securities Law of 1953, §2.1, Ill. Rev. Stat. Ch. 121½, §137.2-1 (1965):

“‘Security’ means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, investment fund share, face-amount certifi-

App. 3

cate, voting-trust certificate, fractional undivided interest in oil, gas or other mineral lease, right, or royalty or, in general, any interest or instrument commonly known as a security, or any certificate of deposit for, certificate of interest or participation in, temporary, or interim certificate for receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."

Illinois Securities Law of 1953, §3, Ill. Rev. Stat. Ch. 121½, §137.3:

Exempt securities: The provisions of Sections 5 and 7 of this Act shall not apply to any of the following securities;

* * *

"I. Instruments evidencing indebtedness under an agreement for the acquisition of property under contract of conditional sale;

"J. A note secured by a first mortgage upon tangible personal or real property when such mortgage is made, assigned, sold, transferred and delivered with such note or other written obligation secured by such mortgage, either to or for the benefit of the purchaser or lender; or bonds or notes not more than 10 in number secured by a first mortgage upon the title in fee simple to real property if the aggregate principal amount secured by such mortgage does not exceed \$50,000 and also does not exceed 75% of the fair market value of such real property;

* * *

"L. Negotiable promissory notes and drafts, bills of exchange and bankers' acceptances which arise out of current transactions or the proceeds of which have been or are to be used for such current transactions, but only if such notes, drafts, bills or acceptances have a maturity at the time of issuance of not to exceed 9 months; and any renewal or renewals, the maturity of each of which is similarly limited, of such notes, drafts, bills or acceptances;"

No. 104

In the
Supreme Court of the United States

OCTOBER TERM, 1967.

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Petitioners,

vs.

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Respondents.

**On Writ Of Certiorari To The United States Court
Of Appeals For The Seventh Circuit.**

**REPLY BRIEF FOR
ALEXANDER TCHEREPNIN, ET AL.**

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**REPLY BRIEF FOR
ALEXANDER TCHEREPNIN, ET AL.**

The briefs filed by respondents demonstrate that petitioners' position is unassailable. They do not attempt to gainsay the accuracy of any except a very minute part of petitioners' array of facts and of statutory and case law. The details of the formal and of the substantive characteristics of the investment interests here under consideration, as so depicted by petitioners with precision, are thus virtually undisputed.¹

¹ Where respondents occasionally raise a question of accuracy, the sources cited in petitioners' brief establish that it is respondents and not petitioners who have misread the Illinois Act as well as cases cited, and are in error. For copious examples of errors by respondents in reading text and misapprehension of meaning of cases, cf., Petitioners' Reply to Respondents Brief In Opposition to the Petition for Certiorari; also compare current briefs.

Yet, respondents virtually ignore these legal realities. They argue *inter alia* that the substance of the investment relationship here is that of a creditor-debtor indebtedness, which both the Illinois Savings and Loan Act, Ill. Rev. Stats. (1963) c. 32, §§ 701-944, (hereafter "the Illinois Act") and the Illinois Supreme and Appellate Courts say it is not. *Gorham v. Hodge*, 6 Ill. 2d 31, 41, 126 N.E. 2d 626, 631 (1955); *Marshall Savings & Loan Association v. Henson*, 78 Ill. App. 2d 14, 222 N.E. 2d 255 (1966) (Pet. Br. 21, 23, 28).

Such shares and share accounts of an Illinois association are creatures of the Illinois Act. The Act constitutes enabling and restrictive legislation for the purpose of promoting thrift and home ownership through investment in such associations. It specifies in intricate detail that these interests are capital shares and share accounts, both by name, (§ 761)² and by careful delineation of substantive characteristics (Pet. Br. 4-11, 18, 20-24).

I.

Underlying Equities Cannot Influence The Determination Of Whether Or Not These Capital Shares Are A "Security", But In Any Event No Inequity Exists.

Respondents seek to reject all of that as mere formalism, along with the contracts under which these investments were sold to petitioners as alleged in the Amended Complaint, which allegations stand admitted before this Court for present purposes. This case is here on writ of certiorari as the ultimate result of an interlocutory appeal by the present respondents from the trial court's order denying respondents' Motions to strike or dismiss "the

² Citations by section number only are to the Illinois Act.

Complaint for failure to state a cause of action. It is that order sustaining the Complaint which was properly before the Court of Appeals, not the Answers to the Complaint, and the controlling questions involved in that order are those set out in the Petition for Writ of Certiorari granted by this Court.

Accordingly, respondents' Answers to the Complaint included by them in the record in the Court of Appeals and here are mere make-weight and are not before this Court. The Court of Appeals committed serious error in accepting as true the self serving and untrue statements of alleged facts in the Answers, creating a background of untrue and prejudicial notions which that Court expressly referred to in its opinion, and in that false context held that the investment interests here involved are not a "security" within the meaning of § 3(a)(10) of the Securities Exchange Act of 1934 (15 U.S.C., 78c (a) (10)) (hereafter "the 1934 Act").

In their briefs here, respondents, as in the Court of Appeals, again argue the untrue and inflammatory allegations of their Answers as though they were established facts after a trial on the merits. The Answers incorrectly state that a lawful "voluntary" liquidation is pending; that respondent liquidators were elected in a meeting lawfully conducted; that a plan of voluntary liquidation was lawfully adopted; that the state officials are mere stakeholders here; that they stand ready and willing to and are lawfully carrying out their duties pursuant to Illinois law in the liquidation of City Savings Association (hereafter CSA); that unfairness or hardship would result from a holding by this Court that these investment interests are a "security" within the scope of the anti-fraud provisions of the 1934 Act; and that petitioners were not defrauded.

All these are issues properly to be resolved at the trial level. At that time petitioners expect *inter alia* to prove that they were defrauded in the purchase of these investment interests, as charged in the Complaint; that in fact petitioners could not withdraw their money at will, because CSA enforced the contract restrictions against withdrawals by fraudulently concealing facts which gave rise to the purported statutory right to withdraw at will, and that CSA did not have the cash with which to honor, and refused to honor the withdrawal requests of petitioners even in those instances when such requests were made; that the proxies solicited for the meeting to authorize the so-called "voluntary" plan of liquidation and to elect the liquidators were unlawfully solicited through fraudulent misrepresentations; that under Illinois law it is legally impossible to have a "voluntary" liquidation without Court supervision in situations, as here, where the sayings and loan association is insolvent in the sense that its assets are substantially less than the claims of its creditors and investors; that the pre-1959 investors will not be treated inequitably if petitioners prevail, and that *in fact a substantial part of petitioners' money has already been paid to those pre-1959 investors.* (R. 39).³

Except as alleged in the Complaint, all such matters are totally irrelevant here.

With the allegations of the Complaint taken as true, it is grotesque for respondents to posture here that in-

³ In due course the Complaint will be amended to enlarge the relief sought against particular defendants, as warranted by information discovered since this action was filed. Respondents took an interlocutory appeal from the order denying their motions to dismiss. They erroneously assume that any relief sought on the trial will be limited to the present prayers of the Complaint.

equities would result to other investors in CSA if petitioners are granted relief. The remarkable result of respondents' argument would be that any corporation, whether a savings and loan association or engaged in another business, whose assets have been lost through adversity, or have been pilfered or dissipated by dishonest management, could with impunity sell a quantity of securities by fraudulent and manipulative devices and thereby replenish the corporate coffers. Assuming the fraud is committed only by the officers, the shareholders as innocent beneficiaries of the frauds, but beneficiaries nevertheless, could hardly assert in a court of equity that their innocence, co-equal with that of the defrauded new investors, would make it a hardship on such shareholders to forego the fruits of the fraud committed by their corporate officers.

Respondents use the term "priority" as though it denoted an evil or inequitable device. In truth, preferences and priorities are tools of equity.

Aside from the preference which the law consistently gives to the victims of fraud to have restitution of their money as against those whose agents perpetrated the fraud, no matter how innocent the principals of those perpetrators may be, this inflammatory irrelevancy persistently pressed by respondents in the Court of Appeals and here cannot stand scrutiny in the light of established legal precedent. It is to be remembered that this action is a suit for rescission in a court of equity. For a century this Court has held that courts of equity must apply the rule of absolute priorities and may not resort to notions of curbstone justice to realign the rights of parties in equity reorganizations. The principle is equally applicable here. (*Chicago, R.I. & P. Railroad Co. v. Howard*, 7 Wall. 392 (1869); *Northern Pacific Railway Co. v. Boyd*, 228

U.S. 482 (1913); *Case v. Los Angeles Lumber Products Co.*, 308 U.S. 106, 60 S.Ct. 1 (1939)).

Respondents contend that the only distinction between petitioners and other investors in CSA is based on the historical date when they became investors. That would be true *only* if the allegations of the Complaint are to be completely ignored, for it alleges that petitioners are persons who were defrauded in the purchase of their investments through misleading and deceptive representations. In this respect petitioners and investors similarly situated are in an entirely different situation than those investors who were not so deceived.

Of course, all of that is really irrelevant. On the trial it will be necessary for petitioners to establish the allegations of the Complaint. The same is true as to the "persons similarly situated" in the class represented by them, as indicated in the Complaint. (Last sentence, ¶23, Rec. 12). Petitioners purchased their shares in CSA since July 23, 1959 (Rec. 4-5). Investors in CSA prior to that day were those persons who had been on a restricted pay-out basis since about 1957, so that as to the money they already had invested and any new money thereafter invested by them in CSA, they were knowledgeable (Rec. 10-11, Compl. ¶21) and thus undeceived in the sense of Section 10(b) of the 1934 Act, as distinguished from those post-July 23, 1959 investors who were not so knowledgeable.

The Complaint here by Petitioners is brought in their own behalf and on behalf of other persons similarly situated. The persons qualifying within the class necessarily remain indefinite until determined by the trial court. (See Rule 23(c) FRCP). Whether any of the investors in the post-1959 class were privy to knowledge of the true

material facts, as were the pre-1959 shareholders, remains for that court to decide.

II.

Respondents Concede That These Capital Shares Fall Within Several Descriptive Categories Of What Constitutes A "Security".

Petitioners' Brief establishes on the basis of the investment contract between the investor and City Savings Association (hereafter "CSA"), that the investments here are a "security" for federal purposes within the definition of that term in §3(a)(10) of the 1934 Act, 15 U.S.C., §78c(a)(10). This is supported by the detailed provisions of the Illinois Act and by what this Court has held to be the substance of the investment relationship which qualifies an instrument to be a "security" under the Securities Act of 1933 (28 USC §77a *et seq.*) (hereafter "the 1933 Act"). Specifically, they are a "stock," "certificate of interest or participation in any profit-sharing agreement," "transferable share," "investment contract," and, in addition, are "commonly known as a 'security.'"

Respondents' Briefs do not directly answer petitioners' as to three of these descriptive designations, *i.e.*, "certificate of interest or participation in any profit-sharing agreement," "transferable share" and "investment contract." Apparently, they have placed their hopes on somehow convincing this Court that these investment interests are not "stock," and are not "commonly known as a security" or were intended by Congress to be excluded from the benefits of the civil anti-fraud remedies under the 1934 Act. Even, *arguendo*, were these not "stocks" or "commonly known as a security," no one designation in the definition is a limitation or restriction upon any other (Pet. Br. p. 19), so that the three undisputed designations would still apply.

Respondents have seized upon peripheral, minor and irrelevant similarities to other situations and argue that those are "overwhelming" and controlling, both as to the substance of these investment interests and of the investment relationship. Respondents also allege fancied but non-existent distinctions between these and other investment interests which are admittedly within the scope of "security" as defined in §3(a)(10) of the 1934 Act. (CSA Br. 9-10; Knight Br. 8).

The bulk of their briefs consists of irrelevant digressions. Therefore, correction of all the profuse errors committed by them in the course of these digressions is unnecessary, and this Reply Brief, for the most part, is limited to pointing out the major errors upon which their arguments are based.

As heretofore stated, respondents contend that the interests before this Court involve a creditor-debtor relationship. Their argument is not responsive to Petitioners' brief and the authorities therein relied on (p. 22-24). Assuming *arguendo* that such a relationship was involved, respondents' considerable effort to persuade this Court that these interests are for that reason "excluded" from the scope of the 1934 Act is misdirected.

This entire argument of respondents rests on the fact that the phrase "evidence of indebtedness" appearing in the definition of "security" in the 1933 Act⁴ does not

⁴ Section 2(1) of the Securities Act of 1933 defines "security" as: "(1) the term 'security' means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting-trust certificate, certif-

happen to appear in the 1934 Act definition. Respondents have failed to note that in the 1933 Act definition the expressions employed to designate the various investment interests included under the definition of "security" overlap each other to a substantial extent. The same overlap characterizes the expressions employed in defining "security" in § 3(a)(10) of the 1934 Act. Almost the same terms are used in both definitions.

In the present case at least five descriptive expressions found in both definitions include the interests here involved. Assuming *arguendo* that "evidence of indebtedness" also described these interests, which it does not, the mere unexplained omission of that expression from the definition in the 1934 Act cannot be construed to exclude these interests from coverage by the other five terms. There is a great difference between an intent to omit a particular descriptive phrase and an intent to exclude everything that phrase might designate, or everything having an alleged peripheral similarity thereto.

If such omission were equivalent to intent to exclude, a blueprint for committing fraud would exist. Although other descriptive expressions in the definition are broad enough to include most evidences of indebtedness (also a "note", "bond" or "debenture," which are specifically included under the 1934 Act by name), anyone desiring to escape the 1934 Act would need only dress up his

*(Continued)

icate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing." (15 U.S.C. § 77b(1)).

investment securities as such other types of evidence of indebtedness and claim the alleged exemption.

It must be further noted that respondents admit that the Congressional history of the 1934 Act provides no explanation for omission of the phrase "evidence of indebtedness" from the 1934 Act definition. Mere random speculation as to the reason for omission of one descriptive term is not authority for removing from the reach of the 1934 Act an investment interest designated by five other descriptive expressions in the Act's definition.

In short, respondents contend that the unexplained omission of one of six independently adequate descriptive terms, assuming *arguendo* that "evidence of indebtedness" did here apply, establishes Congressional intent to exclude any interest qualifying under the remaining descriptive terms because it is within the ambit of the omitted phrase. It seems more logical that if Congress intended to exclude a particular kind of security it would have so stated in § 3(a)(10) of the 1934 Act at the point that it expressly provided that the term "security" shall not include "currency" and short term commercial paper. In Section 3(a)(12) Congress expressly exempted certain investment interests, but neither investors' interests in savings and loan associations nor evidences of indebtedness are among those exclusions.

It is patent that nowhere in the 1934 Act or in its Congressional history is there any express or implied exclusion of the investment interests here under consideration from the definition of "security", or any indication that the terms "stock", "transferable share," "investment contract," "certificate of interest or participation in any profit-sharing agreement," or "any instru-

ment commonly known as a 'security' " were to be narrowly rather than liberally construed as in all remedial legislation. Likewise, except as to short term commercial paper, a medium of investment activity historically limited in practice to participation by experts, there is no express or implied exclusion of any debt investments. Respondents' efforts to transmute the equity capital interests here involved into a debtor-creditor relationship are really much ado about nothing.

III.

Section 2 Of The Securities Exchange Act Of 1934 Has Been Misinterpreted By Respondents, But Correctly Read Manifests The Necessity For Regulation Of All Transactions In All Securities On Or Off Securities Exchanges. The Operative Sections Of The Act And Its Preamble Plainly Apply To All Securities Transactions.

The CSA Brief (p. 15) alleges that exclusion of savings and loan shares arises by implication from Section 2 of the 1934 Act. That section is set out in full at pages 1-2 of the Appendix to the CSA Brief. Respondents' reliance on Section 2 is based on a misconception of what the words "over-the-counter markets" mean. The Congressional committee reports on the 1938 amendment to the 1934 Act state that, "Under the Securities Exchange Act of 1934, the over-the-counter markets are deemed to include *all transactions* in securities which take place otherwise than upon a national securities exchange". S. Rep. No. 1455 at 2 and H.R. Rep. No. 2307 at 2, 75th Cong., 3rd Sess. (1938) (emphasis supplied).

Professor Loss states that, "Moreover there are positive indications both in the Exchange Act and in its legislative history that, unless the contrary appears in a particular section, the statute's scope extends to *all transactions* in securities". (Emphasis added). 3 Loss,

Securities Regulation (2nd Ed., 1961) 1467, citing 78 Cong. Rec. 7861 (Rep. Lea) and 8296 (Sen. Steiwer).

There is no policy explicit or implicit in Section 2 of the 1934 Act which would tend to remove a withdrawable capital share in a savings and loan association from the Act's operation. Section 2 is entitled only, "Necessity for regulation" and it includes no definitions, exclusions or exemptions. At the outset it states that in the national interest it is necessary to regulate and control "transactions in securities as commonly conducted upon securities exchanges and over-the-counter markets . . . [and] practices and matters related thereto, . . . and to impose requirements necessary to make such regulation and control reasonably complete and effective. . . ."

Keeping in mind the comprehensive meaning of "over-the-counter markets," it is difficult to conceive broader or more inclusive terms to identify the extent of the subject matter included in the scope of the statute, or to express the opinion of Congress as to the necessity for comprehensive regulation and control with respect to any and all transactions in securities on or off any securities exchange. A multiplicity of reasons why transactions in securities are affected with a national public interest is listed in Section 2. If this section were definitional as to, or a limitation upon, which securities are covered by the Act, and if every reason therein cited would have to potentially apply to every security claimed to be subject to the Act, one would be hard put to find many securities to which it would be applicable. The proof required in each case would be monumental if not prohibitive.

Unambiguous terms of the Act's definition of "security" are to be liberally construed and it would be in-

consistent with the dominating general purpose of the Act to limit the definition by intruding on it, as to each security, the requirement that the entire list of particular circumstances which occasioned passage of the Act, must apply to that security. Moreover, many of the reasons cited in Section 2 *do* apply to the investment interests here under consideration.

As in the Court below, the CSA Brief selects a few lines of Section 2 and adds the word "when", which does not appear in the actual text, to support its position that the Act applies only to a narrowly specified situation. This excerpt including the interpolated "when", they argue, is a "clear expression of Congressional intent . . . that the Act was designed to cover *only* those securities which are negotiable and for which a fluctuating market exists." (Emphasis added). (CSA Brief, p. 15.). First, no requirement of negotiability, as distinguished from transferability by assignment, is either expressed or implied in Section 2.

Second, if the 1934 Act were not to apply to a security without a fluctuating market, all newly issued and unseasoned securities where there is no general information as to their market value, would be excluded. In such situations truthful disclosure is especially important. Fraud could be rampant in the early years of any enterprise, such as the tung-tree case, if the intended federal remedy were not available.

It is common knowledge that the total quantity of securities registered on national securities exchanges or for which a "fluctuating" over-the-counter market exists constitutes only a portion of the total securities involved in the national economy. Those of the vast majority of enterprises constituting the meat and sinew of our economy

are little known and little traded. If the transactions in such securities involving use of the mails or interstate facilities are to be interpreted as not covered by the anti-fraud provisions of the 1934 Act and the victims of fraud in such transactions are thus to be deprived of their civil remedies, a significant portion of the economy would be affected.

Indeed the first private remedy decision under rule 10b-5, as well as many subsequent decisions allowing recovery, involved the securities of closely held companies for which there was no fluctuating market. *Kardon v. National Gypsum Co.*, 69 F. Supp. 512, E. D. Pa. (1946); *Kohler v. Kohler Co.* 319 Fed 2d 634 (1963) 7th Cir.; *Taylor v. Janigan*, D. Mass., Civ. No. 58-1056-M, 4/16/59; *Schine v. Schine*, 250 F. Supp. 822, 823 (S. D. N. Y. 1966).

The "dominating general purpose" of the 1934 Act is to provide for regulation and control of all securities transactions affecting interstate commerce, regardless of by whom, where or how transacted, or whether the securities involved are "negotiable" or have a "fluctuating market". An indication of the scope of the 1934 Act is found in the Act's Preamble, which is not to be confused with §2. The Preamble reads:

"An Act

"To provide for the regulation of securities exchanges and of *over-the-counter markets* operating in interstate and foreign commerce and through the mails, to prevent inequitable and unfair practices on such exchanges and markets, and for other purposes." (Emphasis supplied); (H.R. 9323, Public No. 291-73rd Cong.).

⁵ *SEC v. C. M. Joiner Leasing Corp.*, 320 U.S. 344, 350, 351, (1943), interpreting the definition of "security" in the Securities Act of 1933.

Congressional intent as to both the dominating general purpose and the scope of the 1934 Act is demonstrated by what Congress itself expressly provided in the operative provisions of the 1934 Act.

Congress did not stop with provisions for registration of securities exchanges and with registration of the brokers and dealers who deal in securities on such exchanges and in over-the-counter markets. Its purpose was not limited to regulating and controlling the people in the business of dealing in securities, the securities exchanges and the transactions by those people on such exchanges and in the over-the-counter markets. Congress did provide for such regulation and control and then went on and wrote Section 10 into the Act. Encompassed within Section 10 is *any* person who uses the mails or facilities of interstate commerce in *any* security transaction on or off an exchange.

To insure that no loopholes would occur and frustrate its attempt to reach all fraudulent transactions through Section 10b, Congress provided therein that the SEC may prescribe rules and regulations having the force of law, if the Commission finds them "necessary or appropriate in the public interest or for the protection of investors" in connection with any such transaction. This comprehensive grant of rule-making power to the Commission is persuasive of the "dominating general purpose" of the 1934 Act to regulate and control *any* transaction in "any security" on or off any exchange, by "any person", not excluding non-negotiable securities and those without a "fluctuating market".

It is determinative that in § 10 Congress did not refer expressly as it did in § 2, to transactions in "over-the-counter markets". Instead § 10 places the following in

juxtaposition: "the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange." Sub-section b of § 10 similarly speaks only of "the purchase or sale of any security registered on a national securities exchange or *any security not so registered. . . .*" (Emphasis added).

This with finality eliminates any conceivable room for controversy as to the meaning of "over-the-counter market," for Congress has thus twice in § 10 interpreted that term as used in § 2 and in the preamble to mean any transaction involving the mails or related to interstate commerce, other than on an exchange. Section 10 itself manifests "other purposes," the existence of which the preamble signaled. Respondents' notion that the transactions declared unlawful by § 10 are only those involving securities with a "fluctuating market" (CSA Br. p. 15) and only those which are "negotiable" (CSA Br. p. 15) is thus dispelled.

Rule 10b-5 promulgated by the Commission pursuant to § 10(b) (17 C.F.R. § 240.10b-5) is also illuminating, for it too speaks in the same terms and not in terms of "over-the-counter markets." It serves as an early interpretation by SEC shortly after enactment of the Act, and demonstrates that SEC has not changed its views during the pendency of this suit as charged in the Knight Brief.

IV.

Where An Act Is Plain And Unambiguous There Is No Duty Or Right To Resort To Legislative History, But Here The Legislative History Reinforces The Conclusion That These Withdrawable Shares Are A "Security".

The prolix documentation of the Knight brief coats it with a deceptive gloss of authenticity which disappears

immediately upon examination. The brief is all form and no substance.

Both respondents CSA and Knight in their respective Briefs rely heavily on a Mr. Prather as authority for the historical development of the designation "share" for investment interests in savings and loan associations, and for statements as to the legal nature of the investment relationship between an investor and a savings and loan association. Mr. Prather is not an objective commentator, but is a lobbyist for special interests seeking to promote the views he asserts to be the law without benefit of supporting decisions. It is unseemly to cite his writings in the guise of disinterested authority.

In regard to legislative history, the plain meaning of the statute precludes the need for resort to legislative history.⁶ In *United States v. Oregon*, 366 U.S. 643 (1961), this Court said at page 648 (emphasis added):

"Having concluded that the provisions of §1 are clear and unequivocal on their face, we find no need to resort to the legislative history of the Act."

The words "stock", "certificate of interest in any profit-sharing agreement", "transferable share", "investment contract" and "any instrument commonly known as a 'security'", are clear, unequivocal and unambiguous.

In regard to the 1934 Act, the statute at issue here, there is a complete absence of any legislative history per-

⁶ *Caminetti v. United States*, 242 U.S. 470, 485 (1916) ("Where the language is plain and admits of no more than one meaning; the duty of interpretation does not arise, and the rules which are to aid doubtful meanings need no discussion."); *Hamilton v. Rathbone*, 175 U.S. 414, 421 (1899) (Extrinsic aids may be "resorted to to solve but not to create an ambiguity.")

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taining to the question of whether a withdrawable capital share issued by a savings and loan association was intended to be a security. Although the Knight brief is not entirely clear in this respect, it seems to imply otherwise.⁷ In his dissenting opinion below, Judge Cummings said (R. 54-5): "When Congress enacted the Securities Exchange Act of 1934, there was no discussion of savings and loan interests during the consideration of the definition of a security in that act."⁸

In connection with the enactment of the 1933 Act, there was some Congressional discussion of the issue involved in the present case. The Knight brief takes the incongruous position that the legislative history of the 1933 Act is pertinent, but that judicial interpretations of the 1933 Act are not, in interpreting the definition of security in the 1934 Act (Compare, Knight Br. pages 11-13, 36, with same brief pages 22, 39). But even if the 1933 Act history is examined, it leads to the inevitable conclusion that withdrawable capital shares issued by savings and loan associations were intended to be securities (SEC Brief, pages 16-19).

The only matters relied upon by the Knight brief to rebut the overwhelming evidence that withdrawable capital

⁷ Pages 18-19: "From the exhaustive analysis of the legislative history of the 1934 Act, Congress was well aware of the type of interests herein at issue. Such interests were discussed, debated and thoroughly considered in Congressional reports, records and hearings." See also, last paragraph of page 15.

⁸ The Knight (p. 22) brief appears to agree with Judge Cumming's statement to the effect that ("Possibly the only hint of any Congressional consideration of share accounts with regard to the 1934 Act was the 1963 hearings and the subsequent exemption made in the 1964 amendments") but not until it has strongly implied the contrary.

shares were intended to be securities are two statements by Senator Barkley, in one of which no reference was made to the issues here at hand (p. 16) and in the other of which he read a telegram "from a Kentucky institution" (p. 39). Senator Barkley was not the chairman of the committee handling the bill in the Senate. In *United States v. Oregon*, 366 U.S. 643 (1961), this Court said at page 648 (emphasis added):

"Since the State has placed such heavy reliance upon that history, however, we do deem it appropriate to point out that this history is at best inconclusive. It is true, as the State points out, that Representative Rankin, as Chairman of the Committee handling the bill on the floor of the House, expressed his view during the course of discussion of the bill on the floor that the 1941 Act would not apply to insane veterans incompetent to make valid contracts. *But such statements, even when they stand alone, have never been regarded as sufficiently compelling to justify deviation from the plain language of a statute.*"

See also *McCaughn v. Hershey Chocolate Co.*, 283 U.S. 488, 493, 494 (1931).

The Knight brief (pages 17-18, 31-2), as well as the CSA brief (pages 27-8), next rely upon statements made by William Cary, then Chairman of the SEC, and by Mr. Cohen, in hearings held in 1963 upon bills which later became the 1964 amendments to the 1934 Act. In the first place, neither witness was purporting to throw any light on what a Congress thirty years ago had intended to include in the term "securities".

⁹ See also, Frankfurter, *Of Law and Men* (1956) 67: "A loose statement even by a chairman of a committee, made impromptu in the heat of debate, less informing in cold type than when heard on the floor, will hardly be accorded the weight of an encyclical."

Secondly, Mr. Cary, among his impromptu remarks in 1963, when asked in the House Committee why building and loan associations were not covered by the extension of registration requirements proposed as amendments to the 1934 Act, did reply in part as quoted at page 17 of the Knight brief. But without indicating any omission respondents omit Professor Cary's significant caveat, immediately ensuing, reading,

"May I ask Mr. Cohen to speak to that and maybe Mr. Loomis? *I simply haven't given that any thought.*" (Emphasis added).

It should be further noted that in the first quoted paragraph Professor Cary stated merely that the SEC does not have jurisdiction over building and loan associations *generally*, meaning that SEC does not regulate the operations of such associations as do other Federal regulatory agencies. But that does not mean that Professor Cary believes that anyone effecting a transaction in any security of a savings and loan association through misleading and deceptive devices would find the SEC powerless to seek a remedy under the 1934 Act.

Further, the quoted comments of Mr. Cohen which follow (Knight Br. p. 17-18) disclose that the reason why the securities study project preceding proposal of the 1964 amendments did not include securities issued by savings and loan associations was "because of the number of other areas they were looking at." Thus respondents' inference that the absence of study of savings and loan interests in that project evidences the belief of the Commission that these interests are not securities, is rebutted.

It is further clear from Mr. Cohen's statement (p. 18) that his remarks were directed solely to proposed extension of registration requirements and had nothing to do with the anti-fraud remedies in the 1934 Act. In his off-

hand comments he did not suggest that he had given any thought to the extent of coverage of investment interests in savings and loan shares under such anti-fraud provisions.

It is to be noted that the testimony of Professor Cary provides further evidence that these investment interests are commonly known as shares, for he referred to them as "so-called shares" (Knight Br., p. 31; CSA Br., p. 28). Because a "transferable share" is one of the designations used to define "security" in section 3(a)(10) of the 1934 Act, the views of the chairman of the Commission as to how people refer to these investment interests is pertinent with respect to the catch-all portion of the definition which included "or in general any instrument commonly known as a 'security'".

Most importantly, when Congress in 1964 amended the 1934 Act, the language it used was clear and unequivocal. Section 12(g)(2)(c) provides:

"The provisions of this subsection [registration requirements] shall not apply in respect of—

• • •
"(C) *any security, other than permanent stock, guaranty stock, permanent reserve stock, or any similar certificate evidencing nonwithdrawable capital, issued by a savings and loan association. . . .*"
(Emphasis added). (15 U.S.C. §78l(g)(2)(c)).

Respondents have attempted to characterize congressional intention with respect to savings and loan shares under the 1933 Act by means of excerpting a few statements from the hearings on that Act. To the extent that respondents' excerpts accurately reflect the context from which they are taken, they express only one of the numerous points of view presented in those hearings. Examination of the record of the hearings themselves,

reveals that the fragmentary comments respondents have seized upon fail even to express the most prevalent point of view as to share account coverage manifest therein.

Moreover, a reading of the Hearings on the 1933 Act in the light most favorable to respondents' position discloses no more than vigorous airing of conflicting views which the resultant 1933 Act resolved on a basis which provides no aid to respondents.

In determining Congressional intent from the plain meaning of the language used, the most conclusive evidence of the fact that Congress intended in the 1933 Act to include withdrawable capital shares of savings and loan associations within the definition of "security" is the language of the exemption of only certain, but not all, such capital shares from the registration, but not from the antifraud, provisions of that Act. § 3(a)(5) provides:

"Any security issued by a building and loan association, homestead association, savings and loan association, or similar institution, substantially all the business of which is confined to the making of loans to members (but the foregoing exemption shall not apply with respect to any such security where the issuer takes from the total amount paid or deposited by the purchaser, by way of any fee, cash value or other device whatsoever, either upon termination of the investment at maturity or before maturity, an aggregate amount in excess of 3 per centum of the face value of such security), . . ."
(Emphasis added). (15 U.S.C. § 77c(a)(5)).

Thus, even withdrawable capital shares are subject to the registration requirements of the 1933 Act if (1) less than substantially all business of a savings and loan association is confined to the making of loans to mem-

bers or if (2) the association charges a fee of more than 3% of the face value of "such security." See also the House Report quoted in the Knight brief at page 13.

In other words, even if the association has all the characteristics of a savings and loan association, its securities, though identical to CSA shares, are not exempt from registration requirements if the size of the withdrawal fee charge is excessive or too many loans are made to non-members. Yet, the size of the withdrawal fee or the loans to non-members have nothing whatsoever to do with the intrinsic nature of the investment interest involved. Thus, by its final authoritative expression of intent, in the statutory language of the 1933 Act, as enacted, Congress exempted securities of *some* savings and loan associations, but from *only some* of the provisions of the Act, namely, the registration provisions.

With this in mind, it is noteworthy that throughout the discussion of savings and loan associations during the Congressional hearings which preceded the 1933 Act, the draftsmen of the legislation, the spokesmen for the savings and loan industry and certain of the legislators, expressed views either treating as settled or directly advocating the inclusion of withdrawable capital accounts within the anti-fraud provisions of the Act. Hearings on H.R. 4314 before the House Committee on Interstate and Foreign Commerce, 73rd Cong., First Sess., pp. 70-73, 77; Hearings on S. 875 before Senate Committee on Banking and Currency, 73rd Cong., First Sess., pp. 50-54, 111.

The distinction between including these interests within all the provisions of the 1933 Act, both registration and anti-fraud provisions, or on the other hand only within the anti-fraud provisions was specifically discussed. The draftsmen wanted to include these interests within both

registration and anti-fraud provisions of the statute. Hearings on H.R. 4314 before the House Committee on Interstate and Foreign Commerce, 73rd Cong., First Sess., pp. 75-76; Hearings on S. 875 before Senate Committee on Banking and Currency, 73rd Cong., First Sess., p. 99. Savings and loan industry spokesmen wanted exemption of these interests from the registration provisions, while emphatically supporting their inclusion within the anti-fraud provisions.

The limited exemption from registration of investment interests in savings and loan associations, as enacted in the 1933 Act, was decidedly narrower than the exemption proposed by industry representatives. Also, no exemption was provided any savings and loan investment interests from the anti-fraud provisions of the 1933 Act. Sections 12 (15 U.S.C. §77l and 17 (15 U.S.C. §77q) of that Act make it expressly and abundantly clear that the exemption accorded securities of some savings and loan associations, based on the behavior of management rather than the intrinsic nature of their securities, was not to include exemption for such securities from the anti-fraud provisions of the 1933 Act.

V.

Section 10(b), Containing The Operative Provisions Here Involved, Expressly Covers Any Security Transaction And Is Not Limited To Those Occurring After Original Issuance Of Securities.

Among the miscellany of alleged reasons advanced by respondents why the investment interests here involved are not a "security" within the meaning of the 1934 Act definition, which is all that is before this Court, the Knight brief suggests that petitioners have failed to establish that no remedy is available to them under the

1933 Act (p. 24) and for that reason they have no remedy under the 1934 Act. This is a non-sequitur. Respondents fallaciously contend that the 1934 Act covers only security transactions after the original issuance.

Section 10b and rule 10b-5 stand in stark rebuttal. They expressly cover *any* transaction in any security by any person on or off a securities exchange. Issuers are not excluded from its expressed comprehensive coverage. Apparently, respondents have the notion that once Congress enacted the 1933 Act, either its power to legislate with regard to the same subject matter was exhausted or that the 1933 Act demonstrated that Congress had decided that there would be no supplementary legislation complementing or expanding the remedies of defrauded purchasers where original issuers commit frauds.

There is no public policy against successive Congressional anti-fraud enactments and Congress has been free at all times to not only broaden the scope of such legislation but to reiterate in successive laws the unlawfulness of securities transactions accomplished through misleading and deceptive devices. In the absence of express Congressional provision restricting defrauded purchasers of securities to the remedy available under the narrowest or earliest of the successive enactments, the option rests with the defrauded purchaser to employ that remedy, express or implied, which may be best suited to his needs.

The Knight brief posits its argument, that if a remedy is available to petitioners under the 1933 Act there can be none under the 1934 Act, on an outdated statement by Professor Loss (Knight Br. p. 24-25) that the Supreme Court "has yet to consider *any* implied remedy under the SEC Statutes. . . ." But this Court has since held in *J. I. Case v. Borak*, 377 U.S. 426, 432-33 (1964) that

there is an implied private cause of action under §14 and Rule 14(a) of the 1934 Act in cases involving violation of the proxy rules, stating:

"Private enforcement of the proxy rules provides a necessary supplement to Commission action. As in antitrust treble damage litigation, the possibility of civil damages or injunctive relief serves as a most effective weapon in the enforcement of the proxy requirements. The Commission advises that it examines over 2,000 proxy statements annually and each of them must necessarily be expedited. Time does not permit an independent examination of the facts set out in the proxy material and this results in the Commission acceptance of the representations contained therein at their face value, unless contrary to other material on file with it. Indeed, on the allegations of respondent's Complaint, the proxy material failed to disclose alleged unlawful market manipulation of the stock of ATC, and this unlawful manipulation would not have been apparent to the Commission until after the merger."

If the volume of work of the Commission in the matter of proxy statements is so great that time does not permit an independent examination of the facts set out in the proxy material, *a fortiori* under Section 10(b) and Rule 10b-5 of the 1934 Act, there is immense need for private enforcement to supplement Commission action. In the immeasurably greater area encompassed by section 10(b) and rule 10b-5, covering any transaction by any person on a registered securities exchange or not on an exchange, the volume of situations requiring scrutiny and possible enforcement is so vast that without private enforcement most violations would go unremedied. The Commission, as in cases under the proxy rules, could not conceivably have the manpower, time or budget to investi-

gate all security transactions on or off exchanges and institute all necessary enforcement proceedings to remedy all violations.

Since *Borak*, a decision has been rendered by this Court in an action for private enforcement of the implied remedy under section 10(b) of the 1934 Act and rule 10b-5 promulgated pursuant thereto. In *Surowitz v. Hilton Hotels Corporation*, 383 U.S. 363 (1966), this Court in holding that the Federal Rules of Civil Procedure were intended "to get away from some of the old procedural booby traps" (p. 373), stated that "it is not easy to conceive of anyone more in need of protection against such schemes than little investors" like the petitioner there (p. 371). The order of dismissal was reversed and the case remanded to the District Court for trial with the comment that it was time the defendants be compelled to admit or deny the charges in the Complaint. *Surowitz* was necessarily a holding by implication that there is an implied private remedy under section 10(b) of the 1934 Act, in favor of a defrauded purchaser of securities.

These two decisions of this Court, both cited by the present petitioners in prior briefs, establish that the citation of Professor Loss' treatise by respondents is outdated and inapposite.

VI.

There Is No Public Policy Against Cumulative Federal Enactments Of Anti-Fraud Laws Relating To Security Transactions.

The suggestion that there is some public policy *against* providing federal remedies for defrauded purchasers of securities permeates all three briefs of respondents. This type of limited control, triggered only by an act of deception in a securities transaction, is confused by respondents

with general regulation of operations of savings and loan associations by state and other federal regulatory agencies.

Respondents premise their argument on the erroneous comment that if a savings and loan association is not in liquidation, a question under section 10(b) could never arise. They say that anyone can withdraw his money at will from any association which is not in liquidation. That, of course, is untrue. It ignores the fact that almost universally in the United States such shares are only conditionally withdrawable, for savings and loan associations have the right unilaterally to limit or stop withdrawals if they have insufficient cash. Such restriction does not constitute a default, if the amount of investors' shares plus liabilities to creditors does not at the time exceed the total value of assets. (Pet. Br. p. 7-8 and footnote 7). In Illinois an association may (but need not) honor withdrawal requests. (Pet. Br. p. 7; § 773(a)).

In CSA the cause of action under section 10(b) arising from deception in the sale of shares to petitioners existed long before the liquidation started. It was fraudulently concealed until shortly after June 26, 1964. Through such concealment petitioners were effectively denied the information which would have caused them to demand their money, and there is nothing in the record to justify the assertion of respondents that requests for withdrawals were honored by CSA, for they were not.

VII.

Archer & Co. v. SEC Demonstrates That As Early As 1943 The 8th Circuit And The SEC Interpreted Withdrawable Investments In A Savings And Loan Association To Be A "Security" Subject To The 1934 Act. The Correct Interpretation By The District Court Here Was Not Novel.

The Knight brief attempts to distinguish the case of *Archer & Co. v. SEC*, 133 F 2d 795 (CA 8, 1943) cited

by petitioners (Pet. Br. 38), by speculating that the investment interests there involved were face amount certificates, rather than share accounts. (Knight Br. 22-23, footnote).

That ignores footnote 17 at page 13 of Petitioners' Reply Brief to Briefs in Opposition to Petition for Writ of Certiorari. It discloses that petitioners were advised that the certificates of Pacific States Savings and Loan Association involved there, actually represented withdrawable capital. This information, as stated, came from state officials in the Division of Savings and Loans of the Department of Investments of the State of California. Respondents' speculation is no proper rebuttal. Respondents do not claim they have any contrary information, but rest on pure speculation from what they argue "appears" in the report of the decision in *Archer*.

From that point, footnote 51 in the Knight brief proceeds to utter confusion. It surmises that the certificates there involved are contemplated under the Investment Company Act of 1940, but the violations in *Archer* occurred in 1937, three years earlier. Then it asserts that there is no indication that Pacific States Savings and Loan Association was a true building and loan association which made loans only to its members. That refers to the exemption provided in section 3(a)(5) of the 1933 Act. But that is completely inapplicable because SEC sued *Archer* for violation of section 15 of the 1934 Act. Loss of exemption from registration provided to some associations under the 1933 Act, was not in any way involved in *Archer*.

The CSA brief (p. 28) in turn argues that *Archer* involved more than savings and loan association certificates, because the Court's holding was also based on

fraudulent sales of common stock in violation of the 1933 and the 1934 Acts. What the CSA brief fails to comprehend is that there was an explicit finding in the *Archer* decision that the transactions in the certificates in question constituted a violation of the 1934 Act. (*Archer & Co. v. SEC*, 133 F 2d 795 (CA 8, 1943), at 801).

Implicit in that finding is a holding that the withdrawable capital certificates of Pacific States Savings and Loan Association were securities under the 1934 Act, otherwise that court could not have held as it did. The suggestion at page 28 of the CSA brief that the decision contains no indication that the Court was asked to hold whether the certificates in question were securities, ignores the precise holding of the court that the transactions in these Pacific States certificates violated the 1934 Act. (p. 801).

VIII.

Additional Evidence That Withdrawable Interests In Savings And Loan Associations Have Been "Commonly Known As A 'Security'" Prior To And Since Enactment Of The 1934 Act Is Supplied By Respondents' Own Briefs.

Even greater confusion exists in respondents' efforts to avoid the catch-all clause, "or in general, any instrument commonly known as a 'security'." Except for a casual reference, it might appear that respondents overlooked the comprehensive coverage of this point in Part II of petitioners' Brief (pp. 28-40). It includes numerous citations to broad usage in Illinois and elsewhere which respondents have been unable to refute, demonstrating that these interests have been "commonly" so regarded.

It may be recalled that the pivotal holding of the lower Court on which its finding turns that these interests are

not "commonly known as a 'security'" (R. 47), is based on a misconception of the Illinois Act. (Pet. Br. 29 et seq.). That was due to the Court's error in finding significance in respondents' argument that section 2 of the 1934 Act establishes that it applies only to "negotiable" securities as distinguished from investment interests which are "transferable by assignment."

It is natural that the Illinois legislature would except from the operation of the Commercial Code securities article dealing only with negotiable securities, the non-negotiable securities of Illinois savings and loan associations. But that is far from providing that these are not securities.

Petitioners' brief cites a very respectable number of Illinois statutes enacted over many years, some at a time when withdrawable capital accounts (shares and share accounts) were the only type of investments in savings and loan interests permitted by Illinois law. In certain instances the word "securities" was used to designate these interests as exempt, as in the Commercial Code and in the Illinois Securities Act. (Pet. Br. p. 30-1). In others, the legislature used the terms "securities" or "shares" to denote these interests for the purpose of authorizing investments therein.

Yet respondent CSA contends that these Illinois Acts are "plainly irrelevant to the issue at bar" because (a) the sections of statutes cited by petitioners are non-definitional in character, and (b) "when these Acts were passed, the Illinois legislature did not at all consider the question in this case . . .". But in situations where the word "securities" was used to identify these investment interests in the years before Illinois associations were authorized to issue other types of investment interests,

the various Acts necessarily were definitional, for they could only have been referring to the type of interests here involved.

As to the second objection, that the Illinois legislature did not consider the question in this case and therefore those statutes are irrelevant, this too is without substance. The relevance here is to whether these interests are "commonly known as a security," which they very definitely were and have been considered over many years prior to passage by Congress of both the 1933 Act and the 1934 Act, and up to the present time. The inference in the CSA brief that petitioners' citations are irrelevant unless the Illinois legislature considered the question involved in this case, viz., the application of the 1934 Federal Securities and Exchange Act, necessarily imports the absurd contrary inference: that the Illinois legislature could pass an Act determining which investments should and which should not fall within the scope of a Federal Act. But that does not mean that in determining whether these interests have been "commonly known as a 'security'," the answer may not be gleaned from Illinois legislation through the years, as well as from other local and national resource material. This has been done by petitioners' brief (pp. 28-40), which establishes that these investment interests are commonly considered a security.

The CSA brief (p. 20) quotes from the House Judiciary Committee's Report on the Bankruptcy Act, 72nd Cong. (1931). Twice in the 4th line of that quotation it identifies this type of investment interest as "securities." Thus three years before passage of the 1934 Act, that Committee considered the word "securities" as the proper way to designate these interests to readers of its Report.

The CSA brief (p. 28) quotes the hereinabove cited 1963 testimony of Professor Cary, the chairman of the SEC, in which he stated that the reason section 12(g)(2)(c) of the proposed [1964] amendments provides for exemption of this type of "share" from proposed extension of registration of securities is that "most savings and loan associations issue *so-called shares*." (Emphasis added). The word "securities" is used by Congress to identify these investment interests in savings and loan associations as being among those exempted from such registration requirements. The same usage occurred in the 1933 Act partial exemption.

Again, at page 10 of the CSA brief, reference is made to Mr. Prather's writings hereinabove mentioned. He is cited as authority that "Throughout the United States it has been held that ownership of accounts in savings associations constitutes not the ownership of 'shares of stock'" It is quite evident that it has *not* so been held "throughout the United States," for there are only a handful of decisions in a few States involving special situations having no pertinence here, such as applicability of tax statutes. The citation of Prather is illuminating, indicating absence of any authority which could be used in rebuttal of part II of petitioners' brief (pp. 28-40).

The Knight brief (p. 28) also cites Prather, and refers to his article in 15 Business Law, 44-69 (1959). That citation has significance only because Mr. Prather there expressly refers to these interests as "*debt securities*" (p. 44). (Emphasis added).

The Knight brief (p. 39) quotes a telegram from a Kentucky institution read at the 1933 hearings in opposition to regulation of investment interests of the type here under consideration. To identify the investment

interests which they wished excluded from regulation, the senders of that telegram used the word "stock," another of the terms which the 1934 Act definition identifies as a "security" thereunder.

The foregoing comments are necessarily only symptomatic of the shortcomings of respondents' briefs.

CONCLUSION.

The dissenting opinion of Judge Cummings represents the correct solution to the questions presented by the interlocutory appeal. The essentials of petitioners' Brief and of the Amicus Brief filed by the Securities and Exchange Commission have not been met by respondents in this Court. It is respectfully urged that the judgment of the Court of Appeals be reversed.

Respectfully submitted,

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November 1967.



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JOHN F. DAVIS, CLERK

No. 104

**In the
Supreme Court of the United States**

OCTOBER TERM, 1967

ALEXANDER TCHEREPNIN, et al.,

Petitioners,

vs.

JOSEPH E. KNIGHT, et al.,

Respondents.

**MEMORANDUM FOR C. ORAN MENSİK,
RESPONDENT**

**KINSEY T. JAMES
7521 Spring Lake Drive
Bethesda, Maryland**

IN THE
SUPREME COURT OF THE UNITED STATES
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ALEXANDER TCHEREPNIN, et al.,

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**MEMORANDUM FOR C. ORAN MENSIK,
RESPONDENT**

OPINIONS BELOW

The opinion of the United States District Court has not been reported and is printed in the Transcript of Record herein at pages 29-33. The majority and dissenting opinions of the United States Court of Appeals for the Seventh Circuit are reported in 371 F.2d 374, and are printed of record herein at pages 43 and 53 respectively.

JURISDICTION

The judgment of the Court of Appeals for the Seventh Circuit was entered on January 20, 1967. The petition for a writ of certiorari was filed April 20, 1967, and was

granted on June 5, 1967. The jurisdiction of this Court rests on 28 U.S.C. 1254(1).

QUESTIONS PRESENTED

1. Did the Court of Appeals for the Seventh Circuit err in holding that a withdrawable capital share issued by a state-chartered Savings and Loan Association was *not* a "stock" within the definition of "security" contained in Section 3 (a)(10) of the Security Exchange Act of 1934, 15 U.S.C. 78c (a)(10)?

2. Did the Court of Appeals for the Seventh Circuit err in holding that withdrawable transferable shares in a mutual Savings and Loan Association are *not* securities within that definition, so that the anti-fraud provisions of that Act are not applicable to purchases and sales of such shares?

THE SECURITY AND EXCHANGE COMMISSION BY ITS OWN STATEMENTS CONSISTENTLY HAS RECOGNIZED WITHDRAWABLE CAPITAL ACCOUNTS NOT TO BE SECURITIES UNDER THE 1934 ACT.

The Security and Exchange Commission, since its creation by the Congress, has been subject to the limitations specifically set out in the 1934 Act and the amendments subsequently enacted. The SEC has consistently recognized its own limitations and down through the years both in public statements and in answer to inquiry by a member of City Savings Association (see appendix 1a) has stated:

"In reply to your letter of September 25, 1953, Savings and Loan Associations are specifically exempt from the registration requirements under the various statutes administered by this Commission."

The Congress being cognizant of the special problems of the Savings and Loan industry, has on many occasions deemed it essential to review all phases of the 1934 Act and has held hearings regularly in its considerations of amendments and new laws in this particular and precise area of federal legislation. It is most significant that during such a hearing before the Subcommittee of the House Committee on Interstate and Foreign Commerce at the 1st session of the 88th Congress, the Chairman of the SEC, William L. Carey testified as follows:

“With respect to savings and loan associations, an effort is made to treat them in essentially the same manner as insurance companies are treated, that is, mutual savings and loan associations will be exempt, just as mutual insurance companies are.

“In the case of stock savings and loan associations, the stock, if purchased and traded as an equity investment, is subject to H.R. 6789 just as is stock of insurance companies.

“On the other hand, savings accounts in savings and loan associations are not subject to the bill, just as insurance policies are not covered. Because of the fact that most savings and loan associations issue so-called shares, which in fact merely evidence the existence of a savings account, special provision had to be made in proposed section 12(g) (2) (C) of the bill to exempt that type of ‘share.’”

It is to be noted that the SEC in its Special Study of the Security Markets (completed after the testimony of Chairman Carey (supra), which study was described as being industry-wide and most comprehensive, there was no treatment of withdrawable accounts, clearly indicating that the SEC itself did not consider such accounts to be “securities” within the ambit of its regulation or control.

The further fact that Congress itself has kept abreast of Savings and Loan institutional growth and its recognition of the constitutionally preserved role of all of the States in their constant and commendable regulation of such local institutions is apparent from the many hearings held by Congressional Committees implementing and affirming this important and necessary federal acknowledgment of the rights of the several States to supervise and control the corporations and associations to which they grant charters. Congress has made its legislative intent in this particular field quite clear by its exemption of State Savings and Loan Associations from the provisions of the Federal Bankruptcy Act and more recently in its enactment of the 1966 amendments to the Federal Savings and Loan Insurance Corporation Act. Such legislation clearly demonstrates the consideration given by the Congress to the unique problems of the Savings and Loan industry and specifically demonstrates the intent of Congress to limit federal regulation and control of such associations and gives recognition to the rights and function of all the several States in their control of local financial savings and loan institutions. Such acknowledgment of the role of the States has been constant and consistently expressed by the Congress in its enactments relating to the savings and loan industry.

In the instant cause the holding of the Court of Appeals for the Seventh Circuit that a withdrawable capital account in a savings and loan association chartered by the State of Illinois is *not* a "security" under the Security Exchange Act of 1934 is manifestly correct.

FEDERAL CONTROL OVER SAVINGS AND LOAN ASSOCIATIONS CANNOT BE PREEMPTED BY THE SECURITIES AND EXCHANGE COMMISSION.

The extent to which the Congress has recognized the constitutional and historical role of the several States in their desirable control and supervision over State chartered local institutions is manifest in the legislative history of all federal legislation bearing upon the savings and loan industry. Whenever federal supervision has appeared needed and deemed warranted by the Congress it has always been enacted with full recognition by the Congress that in this particular field all of the States possess retained constitutional powers that cannot be abridged. The Commissions created by Congress cannot preempt powers and authority with which they have not and/or cannot be vested. The Congress has seen fit to carefully preserve the relationship of State control *vis a vis* Federal regulation in avoidance of potential dangerous and unwarranted clashes of regulatory commissions with each other as well as the several States. The right of the States to control and regulate savings and loan institutions to which they issue charters is of course well settled. The industry-wide experience of savings and loan institutions has shown the Congress that each State does exercise such supervision and Congress has not seen fit to disturb or change this well established practice.

City Savings Association at no time utilized any brokers or agents in connection with the issuance, sale or transfer of the withdrawable "shares" here in question. It is undisputed in this record that this case does not present a factual situation involving such transfers or original issues by agents or brokers of any kind.

All States have regulatory agencies to supervise and control their State chartered savings institutions. City Savings Association was and is under such direct supervision and control in Illinois. The direct regulatory practice of all States includes the regular examination of such institutions and the frequency of such examinations and audits is well known to the Congress. There has been no demonstrated need for a duplication of federal agencies in this phase of the industry.

Congress has long recognized the exclusive powers of all the States to legislate in the field of criminal law and having foreseen the problems of duality in federal-state prosecutions for fraud has consistently deferred to the states in their regulation of State chartered savings and loan institutions.

The S.E.C. in its brief as *Amicus Curiae* refers to the complaint allegations by petitioners that City Savings Association in its solicitations through the mails made statements alleged to be false and misleading. Such complaint states *inter alia*, that the Association had been denied federal insurance and was controlled by a person previously convicted of mail fraud involving other savings and loan associations. It is to be noted that these allegations have no relevance on this appeal which is of course only concerned with the question certified by the District Court to the Court of Appeals for the seventh Circuit on interlocutory appeal.

It is the position of the individual respondents, as former management officials, that such allegations, whether concerned with so-called false advertising, unsafe financial policies or alleged failures to disclose, are not founded upon proof in this record and are specifically and directly denied. Such denial extends to alleged false ads and includes the fact that at no time did the

officers of this association in any way assert that this association had federal insurance (see appendix 2a and 3a). Their association practice was to answer inquiries directly and at no time stated that the association or its depositors were federally insured either by mail, direct advertising or in any manner. The association in its promotion of thrift adhered closely to accepted industry practices and its advertising contained no false or extravagant claims. The association was factually modern, liberal and progressive.

There is no evidence in this record of any failure to disclose any relevant information as would cause improper reliance by members of this mutual association in their purchase of capital shares or the opening of savings accounts. In point of fact, it would be improper for this Association to have commented or published any reference to the mail-fraud trial of its president because throughout the time here pertinent, that case has been pending and is presently under consideration in an appellate court.

All of the States regulate and control the operation of the savings and loan institutions each charters and supervises them constantly throughout their existence.

The extent to which federal regulatory legislation of federal chartered savings and loan institutions deemed necessary by the Congress to parallel the regulation and control exercised by the States over state-chartered institutions has been clearly defined. In its 34th Annual Report (1966) to the Congress the Federal Home Loan Bank Board made the following statement:

"The Federal Home Loan Bank Board was created by Congress almost 35 years ago to meet the urgent needs of the housing and mortgage markets at that

time. It provides aid and supervision for the thrift industry, and for the 12 District Banks serving it, in the following manner:

1. Under the Federal Home Loan Bank Act, to provide a credit reservoir for thrift and home-financing institutions through the Federal Home Loan Banks;
2. Under the Home Owners' Loan Act, to charter and supervise Federal savings and loan association; and
3. Under the National Housing Act, to direct the Federal Savings and Loan Insurance Corporation which provides insurance protection up to \$15,000 for each savings account holder in insured institutions.

Thus the Board combines in one agency the three functions essential to regulation of a financial intermediary—chartering, insurance of accounts, and a central credit pool."

The clear statement of the Board itself is a reaffirmation of the intent of the Congress already expressed in its legislation which gives recognition to the limited extent that federal regulation is deemed needed and constitutionally proper, as well as approval to the strong role exercised by the States in their supervision of savings and loan institutions to which they issue charters. Any change in existing law must of course be made by the Congress and the holding by the Court of Appeals for the Seventh Circuit that a withdrawable account in a savings and loan association chartered by the State of Illinois is *not* a "security" within the definition of the 1934 Act so that the anti-fraud provisions of that Act are not applicable to purchases and sales of such account shares is correct.

For the foregoing reasons these respondents respectfully pray that the decision of the Court of Appeals be affirmed.

Respectfully submitted,

KINSEY T. JAMES

Attorney for Respondents.

C. ORAN MENSIK

ROBERT M. KRAMER

JOSEPH TALARICO, JR.

STANLEY PASKO

GLORIA M. SPRINCZ

ROBERT ZAUCHA



SECURITIES AND EXCHANGE COMMISSION
WASHINGTON 25, D. C.

IN REPLYING PLEASE QUOTE

RTT

September 29, 1953

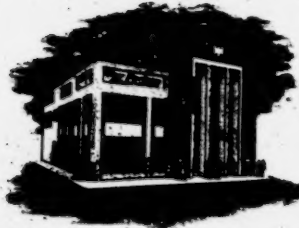
Miss Marianne Barto
3452 W. North Avenue
Chicago 47, Illinois

Dear Miss Barto:

In reply to your letter of September 25, 1953, Savings and Loan Associations are specifically exempt from the registration requirements under the various statutes administered by this Commission.

Very truly yours,

James Hindle
James Hindle
Records Officer



SERVING CHICAGO SINCE 1908

MEMBER FEDERAL HOME LOAN BANK SYSTEM

CITY SAVINGS ASSOCIATION

UNDER STATE GOVERNMENT SUPERVISION

1686 WEST CHICAGO AVENUE . . . CHICAGO 22, ILLINOIS

ANNE H. JERABEK
SECRETARY

PHONE HAYMARKET 1-3800

TO WHOM IT MAY CONCERN:

At no time were we instructed by Mr. Hensch or represented ourselves as stating that City Savings accounts were insured by the FEDERAL SAVINGS AND LOAN INSURANCE CORPORATION.

No such statement has been made by any of us, either verbally or in writing.

Anne H. Jerabek
Anne H. Jerabek, Secretary

Joseph C. Ryan
Joseph C. Ryan, Vice Pres.

Robert M. Kramer
Robert M. Kramer, Vice Pres.

Joseph Salinas, Jr.
Joseph Salinas, Jr., Vice Pres.

Stanley J. Kahn
Stanley J. Kahn, Vice Pres.

Regina Brodzicki
Regina Brodzicki, Asst. Sec'y.

James F. Mako
James F. Mako, Asst. Auditor

Janet Waligorski
Janet Waligorski, Asst. Auditor

Vivian Haly
Vivian Haly, Asst. Auditor

OFFICERS OF CITY SAVINGS ABOVE.

In the Supreme Court of the United States

OCTOBER TERM, 1967

No. 104

ALEXANDER TCHEREPNIN, ET AL., PETITIONERS

v.

JOSEPH E. KNIGHT, ET AL.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT
OF APPEALS FOR THE SEVENTH CIRCUIT

**REPLY MEMORANDUM FOR THE SECURITIES AND EXCHANGE
COMMISSION AS AMICUS CURIAE**

The Securities and Exchange Commission files this memorandum to clarify two matters dealt with in the brief for respondents Knight and Hulman.

1. With respect to the registration as brokers of persons who solicit deposits on behalf of savings and loan associations, respondents state that "[s]uch registration requirement was innovated after the SEC filed its *amicus* brief in the trial court in 1964." (Knight Br. p. 24, n. 53). Respondents are mistaken. Each of the solicitors of savings and loan share accounts to which we referred in our earlier brief (p. 24, nn. 19 and 20 and accompanying text) had been registered with the Commission as a broker-dealer pursuant to Section 15 of the 1934 Act, 48 Stat. 895, prior to the

(1)

commencement of this action on July 24, 1964 (R. 2).¹ Respondents have perhaps been confused by the fact that the Commission did not adopt Form SECO-3 until 1965. That form sought from all registered brokers and dealers who were not members of a registered national securities association information concerning, *inter alia*, the "Principal Type of Securities Business Engaged in" and included, among fourteen possible alternative responses, "Solicitor of savings

¹ For example, the registration of B. C. Morton & Co. Inc., became effective on May 15, 1953. See SEC file No. 8-3532-1, Letter from Anthon H. Lund, Director, Division of Trading and Exchanges to B. C. Morton & Co., Inc., May 15, 1953. As indicated in our earlier brief² (SEC Br. p. 24 n. 19), a certificate in that file shows that in 1961 the firm was engaged exclusively as a solicitor of savings and loan deposits. The registration of Leonard Goldberg became effective April 2, 1955. See SEC File No. 8-4100-1, Letter from Harold C. Patterson, Director, Division of Trading and Exchanges to Mr. Leonard Goldberg, April 1, 1955. In November of that year the registrant reported that "the only activity under the jurisdiction of the Securities and Exchange Commission that I have engaged in has been the opening of savings and loan association accounts on behalf of several clients." See SEC File 8-4100-1, Statement of Financial Condition for the Year 1955, filed November 16, 1955. The Registration of Barber & Kane, Inc. became effective January 22, 1956. See SEC File No. 8-4819-1, Letter from Philip A. Loomis, Jr., Director, Division of Trading and Exchanges to Barber & Kane, Inc., January 20, 1956. In January 1959, that registrant's president certified that "The Security Business of Barber & Kane, Inc. consists solely of the soliciting of investment funds for insured savings and loan associations * * *." See SEC File No. 8-4819-1, Certificate, filed January 21, 1959. The most recent of the registrations of the broker-dealers whose files were referred to in our earlier brief was that of Meyers-Pollock-Robbins, Inc., the registration of which became effective on December 27, 1963. See SEC File No. 8-11797-1. Letter from Anna M. Geiselman, Chief, Branch of Broker-Dealer and Investment Adviser Registration to Meyers-Pollock-Robbins, Inc., December 27, 1963.

and loan accounts.”² In issuing the form, however, the Commission did not impose any new registration requirements; it merely sought information about the nature of the existing registrants’ businesses.

2. Respondents state that the Commission was “in error in quoting from S. Rep. No. 792, 73d Cong., 2d Sess. 14 (1934)” to the effect that the term “security” was defined in the Securities Exchange Act to be “substantially the same as [that contained] in the Securities Act.” (Knight Br. 19) They rely upon the fact that this Senate Report was based upon the definition in S. 3420, which they suggest (Knight Br. pp. 19-20, and n. 45) may have been materially different from that contained in the Act as passed. However, an examination of S. 3420 shows that the definition contained therein was identical to that finally enacted except that S. 3420 contained a somewhat broader exclusion for short-term paper than does the 1934 Act. Thus S. 3420 provided that the term “security”

* * * shall not include currency or any note, draft, bill of exchange, or banker’s acceptance, *or any other similar obligation, which arises out of a current transaction or the proceeds of which have been or are to be used for current transactions, and which has a maturity at the*

² Form SECO-3 was adopted in conjunction with the adoption of Rule 15b8-1, 17 CFR 240.15b8-1, under the Securities Exchange Act of 1934. That Rule “establishes qualifications requirements and fees for registered brokers and dealers who do an over-the-counter business and who are not members of a national securities association registered with the Commission and their principals, salesmen, and other associated persons,” and was adopted pursuant to provisions contained in the Securities Acts Amendments of 1964, 78 Stat. 565, 572-573. See SEC Securities Exchange Act Release No. 7697, September 7, 1965.

time of issuance of not exceeding nine months * * *. [Italicized words omitted from statute as enacted.]

Respondents can hardly draw comfort from the deletion of the italicized language, since that solitary change necessarily tended to broaden, not to narrow, the definition which the Senate Report had characterized as substantially the same as that contained in the Securities Act. The change does suggest, however, the error of the court below (R. 47, 50) and of respondents (Brief for City Savings Association pp. 16-17; Knight Br. pp. 34-38) in relying upon some similarity between savings and loan share accounts and the short term paper excluded from the definition contained in the Act as passed. Even if there were such a similarity, the language of S. 3420, which would have extended the exclusion to "any other similar obligation," was expressly rejected by the conference committee in favor of the language of the House bill which was adopted. Thus, the exclusion was deliberately narrowed to the instruments explicitly described.

Respectfully submitted.

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Securities and Exchange Commission.

NOVEMBER 1967.

Officer

SUPREME COURT OF THE UNITED STATES

No. 104.—OCTOBER TERM, 1967.

Alexander Tcherepnin et al.,	}	On Writ of Certiorari to the United States Court of Appeals for the Sev- enth Circuit.
Petitioners,		
v.		
Joseph E. Knight et al.		

[December 18, 1967.]

MR. CHIEF JUSTICE WARREN delivered the opinion of the Court.

The narrow question for decision in this case is whether a withdrawable capital share in an Illinois savings and loan association is a "security" within the meaning of the Securities Exchange Act of 1934.

The petitioners are a number of individuals holding withdrawable capital shares in City Savings Association of Chicago, a corporation doing business under the Illinois Savings and Loan Act.¹ On July 24, 1964, they filed a class action² in the United States District Court for the Northern District of Illinois, alleging that the sales of the shares to them by City Savings were void under § 29 (b) of the Securities Exchange Act of 1934, 15 U. S. C. § 78cc (b), and asking that the sales be rescinded. Named as defendants in the complaint were City Savings, its officers and directors, two state officials who had taken custody of the Association,³ and three

¹ 32 Ill. Rev. Stat. §§ 701-944.

² The members of the class were identified in the complaint as "more than 5,000 investors [who] have purchased securities [i. e., withdrawable capital shares] of City Savings since July 23, 1959" The total investment of the class members was alleged to amount to "between fifteen and twenty million dollars."

³ The state officials had acted under the authority of 32 Ill. Rev. Stat. § 848. The record does not disclose the precise reason for placing City Savings under state custody. However, the complaint

individuals named as liquidators by the Association's shareholders in voting a voluntary plan of liquidation.⁴ The complaint alleged that the withdrawable capital shares purchased by the petitioners were securities within the meaning of § 3(a)(10) of the Securities Exchange Act,⁵ that the petitioners had purchased such securities in reliance upon printed solicitations received from City Savings through the mails, and that such solicitations contained false and misleading statements in violation of § 10(b) of the Securities Exchange Act⁶ and of Rule 10b-5⁷ adopted thereunder by the Securities and Exchange Commission.⁷ More specifically, the complaint alleged that the mailed solicitations portrayed City Savings as a financially strong institution and its shares as desirable investments. But the solicitations failed to disclose, *inter alia*, that the Association was controlled by an individual who had been convicted of mail fraud involving savings and loan associations, that the Association had been denied federal insurance of its accounts because of its unsafe financial policies, and that the Association had been forced to restrict withdrawals by holders of previously purchased shares.

The defendant-respondents filed motions to dismiss on the ground that the complaint failed to state a cause of action under § 10(b) because the petitioners' withdrawable capital shares were not securities within the

filed in the District Court and the petitioners' brief in this Court suggest that City Savings has been the victim of mismanagement of major proportions.

⁴The voluntary plan of liquidation was formally approved four days after the petitioners had filed their complaint. However, the three liquidators had been nominated prior to the filing of the complaint, and their election had been a foregone conclusion. Voluntary liquidation is authorized by 32 Ill. Rev. Stat. Art. 9.

⁵ 15 U. S. C. § 78c (a) (10).

⁶ 15 U. S. C. § 78j (b).

⁷ 17 CFR § 240.10b-5.

meaning of the Securities Exchange Act. The District Court denied the motions to dismiss, ruling that the petitioners' shares fell within the Act's definition of securities. However, recognizing that the ruling "involves a controlling question of law as to which there is substantial ground for difference of opinion," the District Court certified its order for an interlocutory appeal to the Court of Appeals for the Seventh Circuit under 28 U. S. C. § 1292 (b). The Court of Appeals, with one judge dissenting, agreed with respondents that the withdrawable capital shares issued by City Savings did not fit the definition of securities in § 3 (a)(10) of the Securities Exchange Act. Consequently, it ruled that the District Court was without jurisdiction in the case, and it remanded with instructions to dismiss the complaint. 371 F. 2d 374. Because this case presents an important question concerning the scope of the Securities Exchange Act, we granted certiorari. 387 U. S. 941. We disagree with the construction placed on § 3 (a)(10) by the Court of Appeals, and we reverse its judgment.

Section 3 (a)(10) of the Securities Exchange Act of 1934 provides:

"3. (a) When used in this title, unless the context otherwise requires—

"(10) The term 'security' means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a 'security'; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or

right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace; or any renewal thereof the maturity of which is likewise limited."

This case presents the Court with its first opportunity to construe this statutory provision. But we do not start with a blank slate. The Securities Act of 1933 contains a definition of security⁸ virtually identical to that contained in the 1934 Act. Consequently, we are aided in our task by our prior decisions which have considered the meaning of security under the 1933 Act.⁹ In addition, we are guided by the familiar canon of statutory construction that remedial legislation should be construed broadly to effectuate its purposes. The Securities Exchange Act quite clearly falls into the category of remedial legislation.¹⁰ One of its central purposes is to protect investors through the requirement of full dis-

⁸"2. When used in this title, unless the context otherwise requires—

"(1) the term 'security' means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a 'security'"

⁹*S. E. C. v. United Benefit Life Ins. Co.*, 387 U. S. 202; *S. E. C. v. Variable Annuity Life Ins. Co.*, 359 U. S. 65; *S. E. C. v. W. J. Howey Co.*, 328 U. S. 293; and *S. E. C. v. C. M. Joiner Corp.*, 320 U. S. 344.

¹⁰The Securities Exchange Act was a product of a lengthy and highly publicized investigation by the Senate Committee on Banking and Currency into stock market practices and the reasons for the stock market crash of October 1929. See Loomis, *The Securities Exchange Act of 1934*, 28 Geo. Wash. L. Rev. 214, 216-217 (1960).

closure by issuers of securities, and the definition of security in § 3 (a)(10) necessarily determines the classes of investments and investors which will receive the Act's protections. Finally, we are reminded that, in searching for the meaning and scope of the word "security" in the Act, form should be disregarded for substance and the emphasis should be on economic reality. *S. E. C. v. W. J. Howey Co.*, 328 U. S. 293, 298.

Because City Savings' authority to issue withdrawable capital shares is conferred by the Illinois Savings and Loan Act, we look first to the legal character imparted to those shares by that statute. The issuance of withdrawable capital shares is one of two methods by which Illinois savings and loan associations are authorized to raise capital.¹¹ City Savings' capital is represented exclusively by withdrawable capital shares. Each holder of a withdrawable capital share becomes a member of the association¹² and is entitled to "the vote of one share for each one hundred dollars of the aggregate withdrawal value of such accounts, and shall have the vote of one share for any fraction of one hundred dollars."¹³ The holders of withdrawable capital shares are not entitled to a fixed rate of return. Rather, they receive dividends declared by an association's board of directors and based on the association's profits.¹⁴ The power of a holder of

¹¹ "The capital of an association may be represented by withdrawable capital accounts (shares and share accounts) or permanent reserve shares; or both" 32 Ill. Rev. Stat. § 761 (a). "Permanent reserve shares shall constitute a secondary reserve out of which losses shall be paid after all other available reserves have been exhausted" *Id.*, § 763.

¹² *Id.*, § 741 (a) (1).

¹³ *Id.*, § 742 (d) (2). Each borrower from a savings and loan association automatically becomes a member of the association, *id.*, § 741 (a) (2), but is entitled to only one vote, *id.*, § 742 (d) (4).

¹⁴ *Id.*, § 778 (c). The directors are required to apportion an association's profits at least annually.

a withdrawable capital share to make voluntary withdrawals is restricted by statute.¹⁵ While withdrawable capital shares are declared nonnegotiable and not subject to Article 8 of the Uniform Commercial Code,¹⁶ such shares can be transferred "by written assignment accompanied by delivery of the appropriate certificate or account book."¹⁷

While Illinois law gives legal form to the withdrawable capital shares held by the petitioners, federal law must govern whether shares having such legal form constitute securities under the Securities Exchange Act.¹⁸ Even a casual reading of § 3 (a) (10) of the 1934 Act reveals that Congress did not intend to adopt a narrow or restrictive concept of security in defining that term.¹⁹ As this Court observed with respect to the definition of security in § 2 (1) of the Securities Act of 1933, "the reach of the Act does not stop with the obvious or the commonplace." *S. E. C. v. C. M. Joiner Corp.*, 320 U. S. 344, 351. As used in both the 1933 and 1934 Acts, security "embodies a flexible rather than a static principle, one that is capable of adaption to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits." *S. E. C. v. W. J. Howey Co.*, *supra*, at 299. We have little difficulty fitting the withdrawable capital shares held by the petitioners into that expansive concept of security. Of the several types of instruments designated as securi-

¹⁵ *Id.*, § 773.

¹⁶ *Id.*, § 768 (c).

¹⁷ *Id.*, § 768 (b).

¹⁸ Cf. *S. E. C. v. Variable Annuity Life Ins. Co.*, 359 U. S. 65, 69.

¹⁹ "[T]he term 'security' [in the Securities Act of 1933 is defined] in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of security." H. R. Rep. No. 85, 73d Cong., 1st Sess., 11 (1933).

ties by § 3 (a)(10) of the 1934 Act; the petitioners' shares most closely resemble investment contracts. "The test [for an investment contract] is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others." *Id.*, at 301. Petitioners are participants in a common enterprise—a money-lending operation dependent for its success upon the skill and efforts of the management of City Savings in making sound loans. Because Illinois law ties the payment of dividends on withdrawable capital shares to an apportionment of profits,²⁰ the petitioners can expect a return on their investment only if City Savings shows a profit. If City Savings fails to show a profit due to the lack of skill or honesty of its managers, the petitioners will receive no dividends. Similarly, the amount of dividends the petitioners can expect is tied directly to the amount of profits City Savings makes from year to year. Clearly, then, the petitioners' withdrawable capital shares have the essential attributes of investment contracts as that term is used in § 3 (a)(10) and as it was defined in *Howey*.²¹ But we need not rest our decision on that conclusion alone. "Instruments may be included within any of [the Act's] definitions, as a matter of law, if on their face they answer to the name or description." *S. E. C.*

²⁰ 32 Ill. Rev. Stat. § 778.

²¹ The Court of Appeals refused to apply the *Howey* test in this case. It did not view the petitioners as entering a common enterprise with profits to come solely from the efforts of others because "profit is derived from loans to other members of the savings and loan association." 371 F. 2d, at 377. That analysis, however, places too much emphasis on the fact that, under Illinois law, anyone who borrows from a savings and loan association automatically becomes a member of the association. 32 Ill. Rev. Stat. § 741 (a)(2). It also overlooks the several other classes of investments which Illinois savings and loan associations are authorized to make. *Id.*, §§ 792-792.10.

v. *C. M. Joiner Corp.*, *supra*, at 351. The petitioners' shares fit well within several other descriptive terms contained in § 3 (a)(10). For example, the petitioners' shares can be viewed as "certificate[s] of interest or participation in any profit-sharing agreement." The shares must be evidenced by a certificate,²² and Illinois law makes the payment of dividends contingent upon an apportionment of profits. These same factors make the shares "stock" under § 3 (a)(10). Finally, the petitioners' shares can be considered "transferable share[s]" since "the holder of a withdrawable capital account may transfer his rights therein absolutely or conditionally to any person eligible to hold the same."²³

Our conclusion that a withdrawable capital share is a security within the meaning of § 3 (a)(10) is reinforced by the legislative history of federal securities legislation. When Congress was considering the Securities Act of 1933, representatives of the United States Building and Loan League appeared before House and Senate committees to plead the cause of the League's members. The League's spokesmen asked Congress for an exemption from the Act's registration requirements for building and loan association shares. The spokesmen argued that the cost of complying with the registration requirements whenever a building and loan association issued a new share would be prohibitive. However, the League's spokesmen emphatically endorsed the coverage of building and loan associations under the Act's antifraud provisions.²⁴ Thus, Morton Bodfish, the League's Executive

²² *Id.*, § 768 (a).

²³ *Id.*, § 768 (b).

²⁴ Hearings on H. R. 4314 before the House Committee in Interstate and Foreign Commerce, 73d Cong., 1st Sess., 70-75 (1933) (testimony of Morton Bodfish, Executive Manager, United States Building and Loan League); Hearings on S. 875 before the Senate Committee on Banking and Currency, 73d Cong., 1st Sess., 50-54

Manager, told the House Committee on Interstate and Foreign Commerce:

"When a person saves his money in a building and loan association, he purchases shares and nearly all of our \$8,000,000,000 of assets are in the form of shares

"The practical difficulties of an association having to register every issue of shares . . . are obvious."²⁵

"[W]e approve vigorously and are quite willing to be subject to section 13, which is the fraud section"²⁶

"Now, gentlemen, we want you to leave the fraud sections there, just as they are, so that [if] any fraud developed in connection with the management of any of our institutions anywhere or under the name of building and loan, this law can be effective and operative."²⁷

Congress responded to the appeals from the building and loan interests by including in § 3 (a) (5) of the 1933 Act an exemption from the registration requirements for "[a]ny security issued by a building and loan association, homestead association, savings and loan association, or similar institution" ²⁸ It seems quite apparent that the building and loan interests would not have sought an exemption from the registration requirements and Congress would not have granted it unless there was general agreement that the Act's definition of

(1933) (testimony of C. Clinton James, Chairman, Federal Legislative Committee of the United States Building and Loan League).

²⁵ Hearings on H. R. 4314, *supra*, at 71.

²⁶ *Id.*, at 73.

²⁷ *Id.*, at 74.

²⁸ 15 U. S. C. § 77c (a) (5).

security in § 2(1) brought building and loan shares within the purview of the Act.²⁹

The same Congress which passed the Securities Act in 1933 approved the Securities Exchange Act in 1934, and the definition of security contained in the 1934 Act is virtually identical to that in the earlier enactment. The legislative history of the 1934 Act is silent with respect to savings and loan shares, but the Senate Report on the Act asserts that its definition of security was intended to be "substantially the same as [that contained] in the Securities Act of 1933." S. Rep. No. 792, 73d Cong., 2d Sess., 14 (1934). In addition, when Congress amended the 1934 Act in 1964 to provide for the registration of certain equity securities, it provided an exemption for "any security . . . issued by a savings and loan association" 15 U. S. C. § 781 (g)(2)(c). Thus, the 1934 Act has a pattern of coverage and exemption of savings and loan shares similar to the pattern in the 1933 Act.³⁰

²⁹ The view expressed by the building and loan association interests in 1933 has not changed over the years. The United States Saving and Loan League, in its Membership Bulletin, made the following comments on the Court's decision to hear this case:

"This case is not necessarily as significant and earth shaking in its implications as many savings and loan people assume. In the first place the savings and loan business always has assumed that it was subject to the antifraud provisions of the Securities Acts relating to advertising practices, etc. Regardless of how this case goes it does not mean that savings and loan associations will be any more involved with the SEC than they have been in the past. It does not mean that associations would have to register with the SEC and be subject to all the rules that apply to typical securities transactions."

United States Savings and Loan League, Membership Bulletin, June 28, 1967, p. 15.

³⁰ The Court of Appeals rejected the view that we take of the legislative history of federal securities legislation with respect to savings and loan association shares. In effect, the Court of Appeals

We view the Court of Appeals' conclusion that the petitioners' withdrawable capital shares are not securities as a product of misplaced emphasis. After reviewing the definition of security in § 3(a)(10), the Court of Appeals stated that "[t]he type of interest now before us, if it is covered by this definition, must be 'an instrument commonly known as a security.'" 371 F. 2d, at 376. Thus, the Court of Appeals read the words "an instrument commonly known as a security" in § 3(a)(10) as a limitation on the other descriptive terms used in the statutory definition. This, of course, is contrary to our decision in *Joiner* where we rejected the respondents' invitation to "constrict the more general terms substantially to the specific terms which they follow." 320 U. S., at 350. In addition, we cannot agree with the Court of Appeals' analysis which led it to conclude that a withdrawable capital share is not "an instrument commonly known as a security." For example, the Court of Appeals stressed that withdrawable capital shares can be issued in unlimited amounts and their holders have no pre-emptive rights. Yet the same is true of shares in mutual funds, and we have little doubt that such shares are securities within the meaning of

viewed Congress' exemption of savings and loan shares from the registration requirements as what Professor Loss calls "supererogation." 1 Loss, *Securities Regulation* 497 (2d ed. 1961). The Court of Appeals based its argument on the analogy it drew between ordinary insurance policies, which are also exempted from the 1933 Act's registration provisions, and savings and loan shares. The analogy, however, is inappropriate. Congress specifically stated that "insurance policies are not to be regarded as securities subject to the provisions of the act," H. R. Rep. No. 85, 73d Cong., 1st Sess., 15 (1933), and the exemption from registration for insurance policies was clearly supererogation. See *S. E. C. v. Variable Annuity Life Ins. Co.*, 359 U. S. 65, 74, n. 4. The same cannot be said for savings and loan shares, particularly when the spokesmen for those who issue savings and loan shares had told Congress they fully expected to be covered by the 1933 Act's antifraud provisions.

the Securities Exchange Act. The Court of Appeals also emphasized that the withdrawable capital shares are made nonnegotiable by Illinois law. This simply reflects the fact that such shares are not a usual medium for trading in the markets. The same can be said for the types of interests which we found to be securities in *Howey* and *Joiner*.³¹ The Court of Appeals noted further that the holders of withdrawable capital shares are not entitled under Illinois law to inspect the general books and records of the association. Inspection of that nature, however, is not a right which universally attaches to corporate shares.³² In short, the various factors highlighted by the Court of Appeals in concluding that the withdrawable capital shares are not "an instrument commonly known as a security" serve only to distinguish among different types of securities. They do not, standing alone, govern whether a particular instrument is a security under the federal securities laws.

The Court of Appeals thought it highly significant that the term "evidence of indebtedness" appears in the definition of security in the 1933 Act but was omitted from the definition in the 1934 Act. We cannot agree that omission has any controlling significance in this case. For one thing, we have found other descriptive terms in § 3(a)(10) which cover the petitioners' withdrawable capital shares. The Court of Appeals' emphasis on the omission of "evidence of indebtedness" from § 3(a)(10) flowed from its conclusion that the petitioners' "relationship with the enterprise is much

³¹ In *Howey*, this Court ruled that interests in orange groves were securities under the 1933 Act. In *Joiner*, it held that oil leases were securities under the Act.

³² See Baker & Cary, *Cases on Corporations* 739-741 (3d ed. 1958).

more that of debtor-creditor than investment." 371 F. 2d, at 377. That assertion, however, overlooks the fact that, under Illinois law, the holder of a withdrawable capital share does not become a creditor of a savings and loan association even when he files an application for withdrawal.³³ For this reason alone, the omission of the term "evidence of indebtedness" from § 3 (a)(10) provides no basis for concluding that Congress intended to exclude the petitioners' withdrawable capital shares from the Act's coverage.

The Court of Appeals sought a policy basis for its decision when it noted that the federal securities laws "were passed in the aftermath of the great economic disaster of 1929. Congress was concerned with speculation in securities which had a fluctuating value and which were traded in securities exchanges or in over-the-counter markets." 371 F. 2d, at 377. This statement suggests, and the respondents have argued in this Court, that the petitioners' withdrawable capital shares are not within the purview of the 1934 Act because their value normally does not fluctuate and because they are normally not traded in securities exchanges or over-the-counter. The accuracy of this assertion is open to question.³⁴ But, more important, it is irrelevant to the question before us. As was observed in *Howey*, "it is immaterial whether the enterprise is speculative or non-speculative." 328 U. S., at 301.

³³ 32 Ill. Rev. Stat. § 773 (f).

³⁴ The SEC, in its brief *amicus curiae* submitted in this case, points out that it granted a temporary exemption from §§ 7, 8, 12, and 13 of the 1934 Act to passbooks of savings and loan associations, which were being traded on the Cleveland Stock Exchange shortly after the Act's passage. The SEC also points out that it has repeatedly enforced the Act's registration provisions against brokers and dealers whose business includes the solicitation of funds for deposit in savings and loan associations. Brief for the SEC, pp. 22-24.

Policy considerations lead us to conclude that these petitioners are entitled to the investor protections afforded by the Securities Exchange Act. We agree fully with the following observations made by Judge Cummings in his dissent below:

"The investors in City Savings were less able to protect themselves than the purchasers of orange groves in *Howey*. These [petitioners] had to rely completely on City Savings' management to choose suitable properties on which to make mortgage loans. . . . The members of City Savings were widely scattered. Many of them probably invested their money in City Savings on the ground that their money would be safer than in stocks. . . . Because savings and loan associations are constantly seeking investors through advertising . . . the SEC's present tender of its expert services should be especially beneficial to would-be savings and loan investors as a shield against unscrupulous or unqualified promoters." 371 F. 2d, at 384-385.

The respondents have argued that we should not declare the petitioners' withdrawable capital shares securities under § 3 (a)(10) because the petitioners, if they are successful in their suit for rescission, will gain an unfair advantage over other investors in City Savings in the distribution of the limited assets of that Association, which is now in liquidation. This argument, at best, is a *non sequitur*. This case in its present posture involves no issue of priority of claims against City Savings. This case involves only the threshold question of whether a federal court has jurisdiction over the complaint filed by the petitioners—a question which turns on our construction of the term "security" as defined by § 3 (a)(10) of the Securities Exchange Act of

1934. It is totally irrelevant to that narrow question of statutory construction that these petitioners, if they are successful in their federal suit, might have rights in the limited assets of City Savings superior to those of other investors in that Association.

Reversed.

MR. JUSTICE MARSHALL took no part in the consideration and decision of this case.